SAFE HARBOR LEASING

HEARING

BEFORE THE

SUBCOMMITTEE ON TAX, ACCESS TO EQUITY CAPITAL AND BUSINESS OPPORTUNITIES

OF THE

COMMITTEE ON SMALL BUSINESS HOUSE OF REPRESENTATIVES

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SAFE HARBOR LEASING

THURSDAY, FEBRUARY 25, 1982

HOUSE OF REPRESENTATIVES, SUBCOMMITTEE ON TAX, ACCESS TO EQUITY CAPITAL AND BUSINESS OPPORTUNITIES, COMMITTEE ON SMALL BUSINESS,

Washington, D.C.

The subcommittee met, pursuant to notice, at 9:51 a.m., in room 2359-A, Rayburn House Office Building, Washington, D.C., Hon. Henry J. Nowak (chairman of the subcommittee) presiding.

Mr. NOWAK. The subcommittee will come to order for today's hearing.

OPENING STATEMENT OF CHAIRMAN NOWAK

Mr. NOWAK. I welcome everyone to the hearing today regarding the utilization by small business of the safe harbor leasing tax provisions. Today's hearing is the first in a series designed to investigate the capital formation needs of small business. This is especially important at a time when general economic uncertainty, high interest rates, and a deepening recession are reducing the various financing and investment options for smaller firms.

Safe harbor leasing was included in the Economic Recovery Tax Act of 1982 for the purpose of extending the new depreciation benefits to businesses which do not have current taxable income. Moreover, leasing has been mentioned by some commentators as an important vehicle for increasing the internal cash flow of capital intensive small firms.

The subcommittee, however, has received numerous letters from small business persons regarding the complexity and general unavailability of the benefit from safe harbor leasing. Many small businesses are concerned that the statute effectively precludes them from becoming lessors in such transactions. Other firms are confused as to the impact that the so-called at risk rules will have on any leasing transactions. Besides these technical problems with the tax law, several firms have raised a most important economic question. This involves an issue as to whether financial institutions will, in fact, find small leasing deals profitable.

When analyzing the safe harbor leasing provisions, there are general policy considerations that must be taken into account as well. The Federal budget cuts of last year are beginning to have a devastating impact on the financial needs of our State and local governments. Many financially strapped urban centers have discovered safe harbor leasing as one means of offsetting reductions in Federal aid. For example, several local governments have utilized

the leasing provisions by selling their transit fleets to private companies.

Another policy consideration which must be considered involves the severe dimensions of the impending Federal budget deficits. According to the Reagan administration's own estimates, there will be a Federal deficit of $98.6 billion in 1982, and $91.5 billion in 1983. Repeal of the safe harbor leasing provisions have been mentioned by many as one means of reducing these deficits. Specifically, the Joint Committee on Taxation estimates the revenue loss associated with these provisions will total $27 billion by 1986.

Congress must weigh these various policy issues carefully. We are all striving for the creation of a vibrant economic climate in which all industrial sectors and regions of the country prosper. It is my intention to see that this is accomplished in the most efficient way possible.

We have some members today who are absent and others who are in markups who will be joining us shortly, but I wanted to start the hearing and get through the opening statements so that we could keep on as tight a schedule as we can. I want to present our colleague Berkley Bedell, who has taken a great deal of time and effort to study the background and the impact of leasing, who from his perspective would like to make an opening statement.

OPENING STATEMENT OF HON. BERKLEY BEDELL, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF IOWA

Mr. BEDELL. Thank you, Mr. Chairman. I appreciate this opportunity to sit once again with the Tax, Access to Equity Capital and Business Opportunities Subcommittee. I wish to commend you for providing this forum to discuss the so-called safe harbor leasing provision of the 1981 Tax Act and its impact upon small business.

Obviously, the new tax leasing scheme is having a significant impact on the U.S. Treasury. The most conservative damage estimates I have seen indicate a revenue loss of $27 billion through 1986, and this comes against the background or other massive revenue losses also caused by the 1981 tax law.

We are here today to discuss ways to change the Tax Code to help small business. Personally, I think the best thing we can do is to call a halt to these huge revenue losses.

High interest rates are killing small businesses today, and high interest rates are fueled by the growing Federal deficit. Despite David Stockman's best efforts, we just cannot cut Government spending as fast as the new tax law cuts Government revenues, and that will lead to ever larger deficits; I think this is madness.

Assuming that we cannot repeal all of the 1981 Tax Act at one time, then I suggest the safe harbor leasing provision is a good place to begin the job. In fact, I am cosponsoring legislation to that effect.

Thus far, the safe harbor leasing provision has provided massive tax subsidies to large corporations, but very little benefit to small businesses. A recent article in the Wall Street Journal entitled "Leasing Breaks Limited for Small Business" makes this point very well.

There are some who suggest that the way to provide equity here is to open up tax leasing even more, so that we might see more small businesses using it, too; I disagree.

Bob Dole, chairman of the Senate Finance Committee, recently called the tax leasing gimmick a "hemorrhage to the Treasury." The best way to deal with a hemorrhage is to close the wound, not to open it wider.

Again, I appreciate very much, Mr. Chairman, your willingness to let me sit with your subcommittee this morning.

[Attachment to Mr. Bedell's statement follows:]

from the Wall Street Journal

February 8, 1982

Leasing Breaks Limited for Small Firms

Small businesses don't get anywhere near the tax benefits big companies receive from the safe-harbor leasing provisions of the Economic Recovery Tax Act of 1981. Most publicly held corporations are likely to become free of paying corporate income tax because of the new law, tax practitioners say.

"They left it wide open for the Occidental Petroleums and IBMs, but they effectively knocked the little guy out of it," says Steven Holub, director of tax services at the accounting firm of Laventhol & Horwath.

The new law recognizes as leases for tax purposes arrangements that wouldn't have qualified under prior law. What used to be considered "sham leases" by the Internal Revenue Service, and thus ineligible for leasing tax benefits, qualify under the new rules. However, other tax provisions that apply to closely held corporations —those in which five or fewer shareholders own 50% or more of the stock—individuals and partnerships, greatly limit the benefits for small companies.

For companies that qualify, the benefits are substantial. Seymour Israel, a New York lawyer specializing in tax leases, offers an example. A big company pays $150,000 in the first year to buy $1 million of equipment from a second company. The equipment is leased back to the second company which is still owed a balance of $850,000 on the purchase price.

Under terms of the lease, the user's rent matches the owner's debt payments, so no additional money changes hands beyond the original $150,000. But the owning corporation avoids $465,000 in income tax in the first five years, more than three times the $150,000 it paid to get into the deal.

Few small companies can work such an arrangement. But they can get some benefits from the new law, Mr. Israel says. Their leases will involve bigger cash outlays and financing from a bank or finance company.

Mr. Israel provides an example from an actual deal involving a $1 million computer. A small company laid out $260,000 in cash to buy the computer for leasing. It owes the balance to a finance company and at the end of the lease will be $127,000 ahead on the deal without counting the value of the computer at that time. That's much less than the big company gained in the previous example.

"This puts many small companies at a competitive disadvantage with publicly held companies," Mr. Israel says. "Over time that disadvantage can be backbreaking."

—Sanford L. Jacobs

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Mr. NOWAK. Thank you very much, Mr. Bedell.

This is sort of a unique hearing, because it is the first of the year regarding this problem. Some other Members of the House and Senate have already made statements regarding this provision and law, and I think it is a very important first hearing, because it will set the tone for whatever follows in both the Senate Finance Committee and our own Ways and Means Committee. Hopefully, we will be able to play a part in looking at the changes, especially in amendments, and how they would affect our small business community.

I want to welcome today from the Department of Treasury, the first witness, David G. Glickman, Deputy Assistant Secretary for Tax Policy. Previously he was a partner with a Dallas law firm. He received his law degree from the University of Texas and has a degree in taxation from Georgetown University. We certainly want to welcome Mr. Glickman before us.

TESTIMONY OF DAVID G. GLICKMAN, DEPUTY ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY

Mr. GLICKMAN. Thank you, Mr. Chairman.

I am pleased to be here today to discuss the liberalized leasing rules of the Economic Recovery Act of 1981, known as ERTA. As you know, Assistant Secretary John Chapoton appeared before the Senate Finance Committee and the House Ways and Means Subcommittee on Oversight last December and discussed in great detail the purpose and design of the leasing rules. I have brought with me a copy of his statement, and I request that it be entered into the record of this proceeding.

Mr. NOWAK. Without objection, the full text will be entered.

[Mr. Chapoton's prepared statement follows:]

PREPARED STATEMENT OF JOHN E. CHAPOTON, ASSISTANT SECRETARY OF THE TREASURY FOR TAX POLICY, DEPARTMENT OF THE TREASURY

Mr. Chairman and Members of this Committee:

I am pleased to be here today to discuss the liberalized leasing rules of the Economic Recovery Tax Act of 1981 (ERTA). The leasing rules have generated a great deal of confusion and misunderstanding. I am happy for the opportunity to further explain these rules and to reemphasize their role in the President's program.

Background

The "safe harbor" leasing rules of the ERTA originated in and were developed by the Office of Tax Policy in the Treasury Department. They were included in the first bipartisan tax bill (H.R. 3849) introduced on June 9, 1981. The tax package considered by the Senate Finance Committee in June, which resulted in H.J. Res. 266, also contained the leasing provisions, as did H.R. 4260, the July 24 bipartisan substitute bill in the House. Thus, these provisions were clearly and conspicuously a part of the bipartisan tax package for capital formation from its inception to its passage in August.

The leasing rules are an integral part of the President's tax program to restore economic growth. All reports up to now indicate that they are working as intended to spur investment. Every lease is associated with spending for new equipment. Much of this spending would not occur otherwise.

"Safe harbor" leases allow all companies making new investments full access to the incentives in the recent tax bill. Without these rules, unequal competition for funds would have arisen, additional financial barriers would have been presented to new companies, and additional pressures for mergers and takeovers would have been created. The new leasing rules do not make otherwise bad investments into good investments, but they do make good investments equally profitable for companies in different tax situations.

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The Investment Incentives of ERTA

To see the need for the new leasing rules, the operation of the investment incentives in the recent tax bill must first be clearly understood. The principal investment incentive in the new law is provided by the Accelerated Cost Recovery System (ACRS). ACRS allows firms to deduct the cost of their investment over a much shorter time period than before. This is a valuable incentive, for when firms must postpone deducting the cost of new assets, the value of those deductions is lowered. A dollar that a corporation can deduct today is usually worth $0.46, because the tax rate is 46 percent. If the company must delay taking the $1.00 deduction for five years, however, its present value is reduced to only $0.26 for a company earning 15 percent on investments. Conversely, accelerating the deductions for expenditures on new equipment increases the value of those deductions to the firm. Accelerating deductions effectively lowers the cost of buying the equipment and raises the after-tax rate of return on that investment.

The increase in after-tax return on equipment that comes from accelerating cost-recovery deductions is the major direct investment incentive in the President's tax program. But these early deductions may occur at a time when the new machine is producing little income. Thus, the deductions will serve their purpose only if they can offset other taxable income. If a company does not have other taxable income or cannot transfer its deductions to firms that can use them, then the accelerated deductions under ACRS will be postponed and much of the investment incentive will be permanently lost.

In any year, many active U.S. corporations are in the position of having no current U.S. tax liability. These include new and young corporations just starting up; companies with particularly large investment plans and, thus, large deductions for cost recovery; and firms with temporary domestic losses, but profitable investment opportunities. More rapid deductions for cost recovery will moderately increase the number of such currently nontaxable companies, and will also increase the number of companies that will reach the statutory limit on current use of the investment tax credit.

An Example

To see how one type of company may be excluded from the new investment incentives of ACRS, consider a new firm, Newco Manufacturing Company (Newco), making a $100,000 investment in equipment. In the first two years of that investment, Newco will be allowed under ACRS to take deductions of $37,000 and an investment credit of $10,000. To use all of these tax benefits Newco will need to have net income in those two years (before ACRS deductions) of approximately $59,000. Even highly

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profitable investments generally do not return income within two years equal to more than one-half of the cost of the investment. Without income from older assets, Newco would have to postpone using some or all of the ACRS benefit, and the new tax bill would have increased Newco's after-tax return on new investment by less than that of other companies. Newco's return from that investment would be lower than that of corporations that can use all the benefits currently.

The essence of the new leasing rules is that ACRS will provide incentives for firms, such as Newco, to invest in new equipment even though their investments have not yet produced large profits. Newco may allow some other firm, Taxable Corporation, which does have significant taxable income, to purchase Newco's $100,000 of new equipment for tax purposes and to lease that equipment back to Newco. This allows Newco to use the equipment in its business, but at the same time permits Taxable Corporation to take the resulting investment credit and accelerated deductions against its other income.

In this typical example, the user of the equipment (Newco, the lessee) provides financing for all but Taxable Corporation's downpayment. The terms of the agreement can be arranged so that rental payments owed by Newco to Taxable Corporation just match the reverse payments for debt service. In addition, the agreement may allow Newco to repurchase the asset at the end of the lease term for a token amount. In such a case, only the downpayment actually changes hands between the two companies. This payment is the agreed value of the tax benefits transferred by the lease.

All of the essential elements of a safe harbor lease transaction are shown in the accompanying three charts. The first chart shows the tax benefits of ACRS and the investment tax credit due to a purchase of a new machine for $100,000. These are all the investment incentives that are available from any purchase of 5-year ACRS property. No extra benefits are created by the lease.

In the second chart, we show the tax implications of a 10-year lease for a typical lessee, such as Newco. The lessee has given up the right to the investment credit and the ACRS deductions, but now has tax deductions each year for rental payments in excess of taxable interest income. Newco has, in effect, retained a share of the tax benefits associated with equipment purchases, but has stretched them out over the term of the lease. If, for example, the lessor makes a downpayment of $29,000 for the property, the lessee will have a total of $71,000 of deductions, providing tax reductions in the pattern shown in Chart II. Thus, the lease arrangement postpones the lessee's deductions until the later years when the investment will generate enough income to use the deductions.

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Turning to the lessor, Chart III shows that the lessor obtains the investment tax credit and some net extra tax deductions in the early years of the lease, but also has extra net taxes due in the later years of the lease. The tax savings in the early years result from cost recovery deductions and the investment credit just as in Chart I, but these are partially offset by a series of extra tax payments through the remaining term of the lease. These extra payments occur, despite the fact that no cash changes hands, because for tax purposes the lessor is credited with taxable rental income and charged with deductible interest payments. These net tax payments of the lessor are exactly equal, every year, to the tax benefits of the lessee.

The Outcome of Leasing

There are three important aspects of such a lease which are illustrated in the charts. First, no extra deductions or tax credits are ever created. The total deductions taken by both parties are just the same as would have been taken if Newco had taxable income from other investments or if Taxable Corporation made the investment directly. They are exactly equal to the legally prescribed ACRS deductions and investment tax credit. The Treasury loses no more revenues than those necessary to provide equal investment incentives to all firms. It might also be noted that an alternative, but much less desirable way to accomplish the same result, would be by actual merger of the two companies.

The second critical point is that virtually all of the tax benefits of ACRS will be passed through to the company actually making the new investment, i.e., Newco. This is because Taxable Corporation, and any other corporation interested in obtaining the investment credit and ACRS deductions, will bid for these by offering favorable lease terms. It is already apparent that the market for such deductions is becoming very competitive. The present value of the stream of tax benefits and future liabilities of the lessor, as depicted in Chart III, is about $29,000 when discounted at 15 percent. Put another way, Taxable Corporation can afford to pay up to $29,000 for this stream if the investment credit and all the deductions are expected to be usable when available, and if the interest cost of funds is no more than 15 percent.

The present value of the total of the available investment credit and ACRS deductions (Chart I) is about $45,000, not the $29,000 paid by the lessor. But this does not mean that Newco loses the difference between the $45,000 of foregone benefits and the $29,000 cash payment from Taxable Corporation. As noted before, Newco still has available deductions over 10 years equal to the amount of its $71,000 net cost of acquiring the property.

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So long as the investment returns a sufficient profit to use these later deductions, the tax savings from them are worth $16,000 in present value terms. Thus, Newco will receive virtually the full $45,000 value of ACRS--$29,000 from Taxable Corporation and $16,000 worth of tax savings of its own.

This is a crucial result, for it means that the investment incentive inherent in ACRS has remained just where it should be--in the hands of the firm that will undertake the new investment and employ the new equipment. Although Taxable Corporation takes the credits and ACRS deductions on its tax returns, Taxable Corporation pays for those credits and accelerated deductions and pays additional taxes. Newco ultimately receives all the benefits of ACRS except transaction fees.

The third essential point about the lease transaction is that it does not encourage Newco to undertake an investment unless that investment is expected to be economically profitable. Leasing does not encourage uneconomical or tax-motivated investment. Even with the lease agreement, Newco makes a substantial investment in the asset, $71,000 in our example, and the income that asset generates will be taxed. Unless the asset produces enough income, Newco will not be able to make a profit on its investment. Leasing does not guarantee a profit for bad investments; it merely provides the same ACRS investment incentives to firms without current taxable income as provided to firms with taxable income. With those incentives equally available, firms can select investments on the basis of their economic profitability, not on the basis of tax circumstance.

Misconceptions About Leasing

I have dwelt at some length on the details of the lease transaction because misunderstanding of these transactions is apparently the basis of much recent criticism of the safe harbor provisions. It has been said, for example, that these leases are a "bonanza" for those profitable companies able to purchase deductions and credits as "tax shelters." The opposite is proving to be the case. We have already begun to see the new rules resulting in more of the benefits passing through to users of the new equipment.

Tax-oriented leasing has been a significant feature of the economy for many years. Prior law, however, restricted and unduly complicated lease arrangements. Consequently, lease transactions required complicated agreements and legal uncertainties resulting in high transaction costs, including large legal and brokerage fees. These high costs reduced the net tax benefit (investment incentive) available to companies making an investment. The new simpler and more precise rules are resulting in lower costs and thus substantially more of the tax benefit will remain with those making the investment and less will go to compensate brokers, lessors and lawyers for taking leasing risks or attempting to avoid them.

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Others have said that the new leasing rules are just another way to "bail out" loss companies. However, the fact that tax leasing will aid companies with economic losses does not detract from the desirability of the new leasing rules. These companies cannot use leases unless they undertake new investment in machinery and equipment. They will not make new investments if they do not expect them to be profitable, with or without leasing. Further, with or without leasing, the marketplace will not provide these firms with the capital to make these investments unless the marketplace also believes the investments will be profitable. There is no sound reason to penalize these firms, once they have withstood the critical analysis of lenders and investors in the free market, by forcing them to incur a higher cost of capital than their competitors. Indeed, such a penalty is singularly counterproductive. For most loss firms to become profitable, they must be able to modernize their plant and equipment. Penalizing them when they do invest only serves to make it more difficult for them to become profitable.

If tax leasing were not allowed, inefficient investment decisions would result. Otherwise-identical firms would face different capital costs depending solely on whether they had income from older assets. For example, Newco, which cannot take advantage of ACRS, might not make a particular investment even though, with the same tax incentives as other firms, that investment would be profitable to Newco and valuable to society. Alternatively, Taxable Corporation, the firm with income from older assets, might undertake the same investment rather than Newco, because of greater tax incentives. This could occur even though Taxable Corporation might lack some of the expertise to pursue the investment as efficiently as Newco. Finally, Taxable Corporation might acquire Newco so as to take advantage of Newco's unused ACRS deductions. Such tax-motivated mergers would serve no economic purpose, but would lead to a greater concentration of economic power.

Some critics have agreed with the importance of investment incentives for distressed companies, but express dismay that profitable companies are also cashing in their unusable tax benefits through leasing. Leasing by profitable companies with no current tax liability is neither surprising nor undesirable. It isn't even new. Many companies with tax losses have routinely used tax leases to make use of depreciation allowances and the investment tax credit. However, such transactions were effectively limited to equipment with a ready resale market, such as airplanes, railroad cars, and oil rigs. The new rules will end this discrimination, making leasing available for all kinds of machinery and equipment, and in the process will provide a larger share of the benefits to the equipment-using company.

A company may be currently nontaxable and yet economically profitable for a number of reasons. Our hypothetical startup company, Newco, is one example. With ACRS, rapid investment growth can result in continuing tax losses for such companies as deductions outpace current incomes. In another case, a company might have worldwide profits subject to tax abroad, but also have losses from U.S. operations resulting in excess foreign tax credits. Leasing provides the incentives of ACRS to such companies for investment in the United States. Leasing may also be of benefit to companies with capital gains income, excess depletion allowances, and perhaps other conditions that limit the current use of deductions. In every case, the same two basic principles continue to hold: (1) every lease is associated with new investment expected to be profitable and (2) no more tax benefits are available to these companies than would be provided to their currently-taxable competitors.

In any year, a disproportionate number of companies with tax losses are small businesses. While such companies may not yet have made use of the leasing provisions because information reaches them more slowly and legal fees are initially large, there is every reason to believe that a ready market for small leases will become available through local financial institutions. Again, without leasing, the potential for job-creating investment by such businesses would be reduced and the market pressure for merger or takeover by mature taxable companies would be increased.

Revenue Effects

One last point to address is the revenue cost of leasing. Before I discuss some unfounded criticisms of our revenue estimates, I want to clarify the interpretation that should be placed on the revenue cost figures. New investment in equipment must be made for leasing to take place. In calendar year 1983, additional leasing attributable to the safe harbor rules is associated with $17.3 billion of investment (see attached Table 1). We can not say for certain how much of this investment would have occurred without liberalizing the leasing rules, but we know that the leases are necessary to provide the full benefits of ACRS, the basic investment incentive in the new law. Therefore, we are convinced that the leasing rules will significantly increase the level of investment. The revenue losses from leasing are one measure of its success--direct costs to the Treasury are associated with the higher levels of investment that our economy needs.

Turning to the accuracy of our estimates, there has been a general misunderstanding which has led to press reports that Treasury underestimated the revenue impact of this provision. In fact, our original cost estimate is consistent with the high volume of leasing we are observing. We expected that the provision would be widely used and, so far, our forecast appears to be on target. The first-year revenue loss estimate is based on an estimated total of $17.8 billion of safe harbor leases in 1981. This is well within the range of press reports.

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As shown in the attached table, our estimate of foregone receipts remains $29.1 billion over the six-year period, 1981-1986. This estimate is associated with $126 billion of equipment that would not have been leased in absence of the safe harbor rules. These induced leases are, however, less than half of the total dollar volume of safe harbor leases which we estimate will occur. The remainder of the observed safe harbor leasing activity consists of leasing that would have occurred anyway, under prior law or under the general provisions of ACRS. Some of those leases induced by the general provisions of ACRS would have taken the form of actual mergers rather than leasing arrangements in absence of the safe harbor rules.

To the extent that leasing activity is attributable to prior law or to the general provisions of ACRS, there is no further revenue loss to the Treasury. Revenue costs associated with this activity have already been properly included in the general level of corporate receipts. (See Table 2.)

Conclusion

Mr. Chairman, let me conclude by pointing out that this is a particularly inopportune time to talk about reducing any incentives to invest in new machinery and equipment. This investment is important for job creation in the near-term, and for productivity and economic growth in the years ahead. The safe-harbor lease provision is a market-oriented means of providing equal and effective investment incentives to all businesses.

The Administration does not favor any legislative changes in this provision. It is an efficient incentive, and according to every report, it is working very well. The new leasing rules deserve the continued support of the members of this Committee.

Attachments

93-087 O—82——2

Chart I

Investment Credit and ACRS Deductions

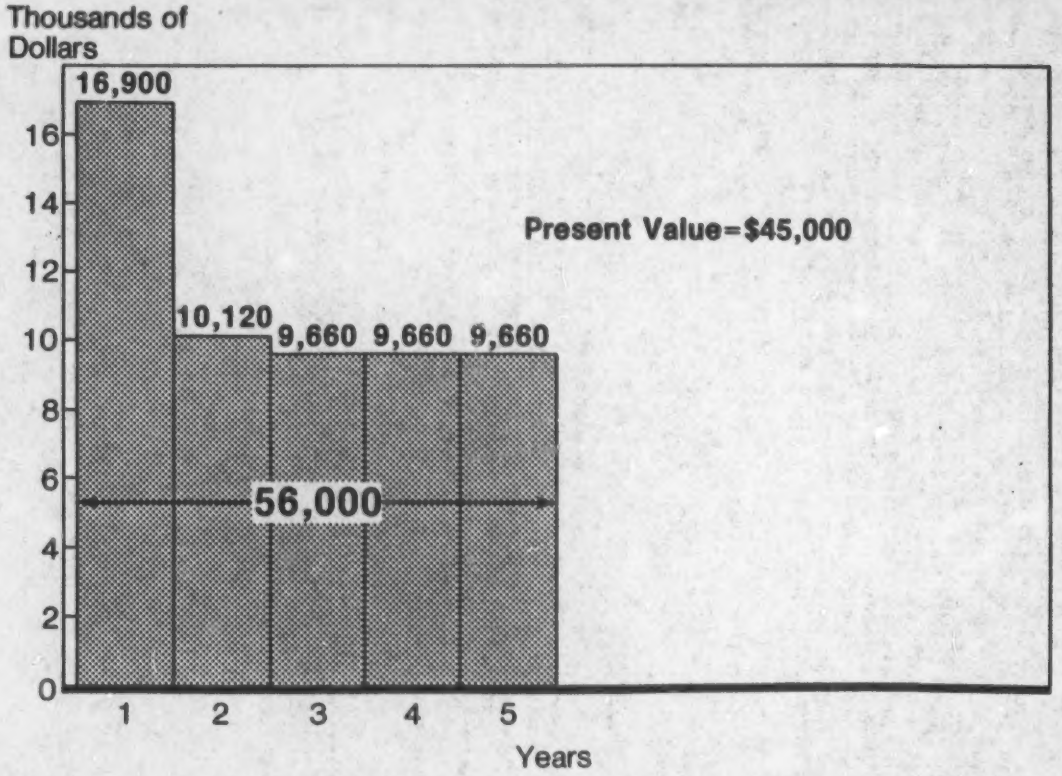

Chart II

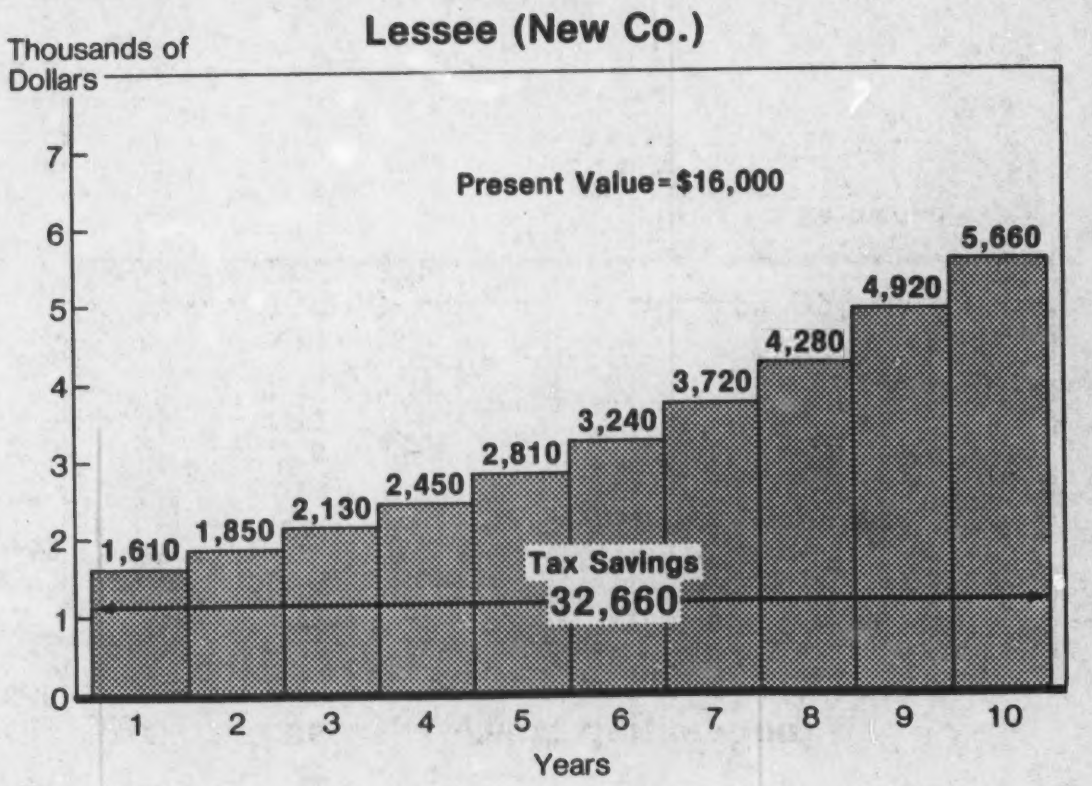
Lessee (New Co.)
Thousands of Dollars
Present Value=$16,000
1,610
1,850
2,130
2,450
2,810
3,240
3,720
4,280
4,920
5,660
Tax Savings
32,660
0
1
2
3
4
5
6
7
1
2
3
4
5
6
7
8
9
10
Years

Chart III

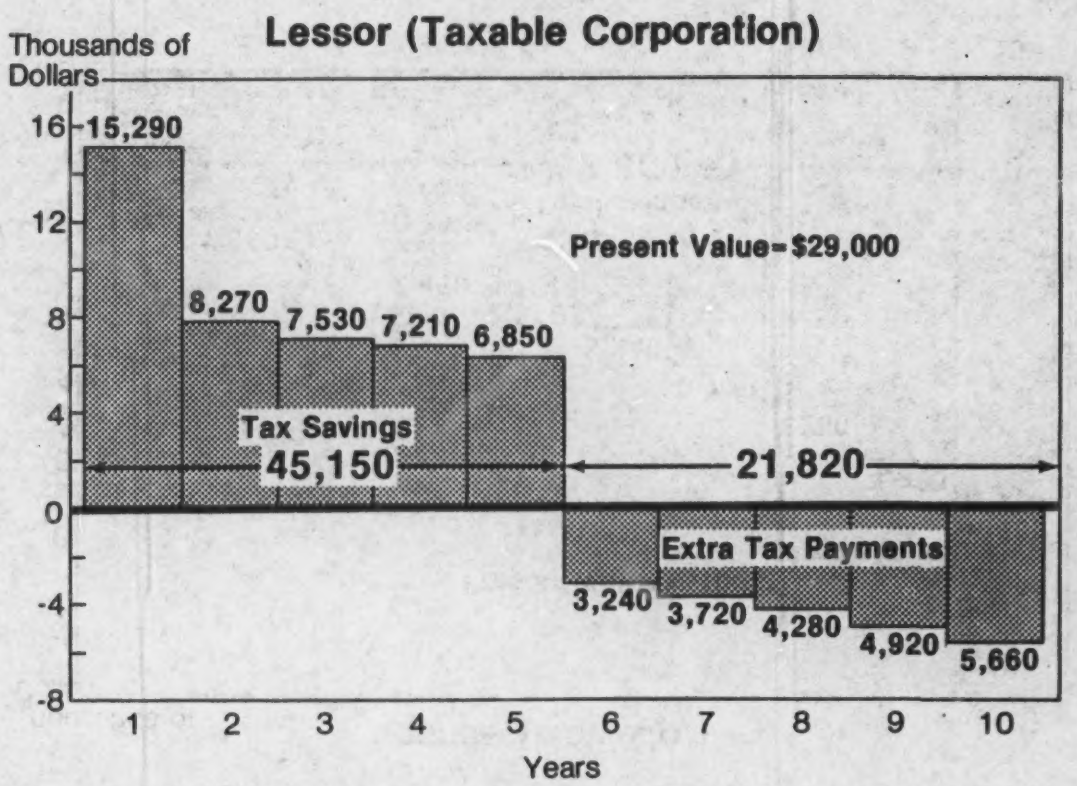
Lessor (Taxable Corporation)
Thousands of Dollars
16
12
8
4
0
-4
-8
15,290
8,270
7,530
7,210
6,850
3,240
3,720
4,280
4,920
5,660
Present Value=$29,000
Tax Savings
45,150
21,820
Extra Tax Payments
1
2
3
4
5
6
7
8
9
10
Years

Table 1

Estimates of Safe Harbor Leasing and the Loss in Receipts Attributed to the Safe Harbor Leasing Rules

($ billions)

	Years					
	1981	1982	1983	1984	1985	1986
Total value of equipment leased under the safe harbor rule.....	17.8	29.0	39.2	46.8	59.6	70.9
Less the value of equipment leased under the safe harbor rule which would have been leased under prior law.....	5.0	11.0	12.1	13.3	14.6	16.1
Less the value of equipment leased under the safe harbor rule which would have been leased under the general provisions of ACRS 1/.....	2.0	4.3	9.8	11.7	17.4	20.0
Equals the value of equipment leased under the safe harbor rule which would not have been leased under prior law or under the general provisions of ACRS.....	10.8	13.7	17.3	21.8	27.6	34.8
Loss in fiscal year receipts from incremental leasing added by the safe harbor rule....	0.5	2.7	3.8	5.4	7.3	9.4

Office of the Secretary of the Treasury
Office of Tax Analysis

December 8, 1981

1/ Included in these figures are investments made by nontaxable corporations which would have been merged into taxable corporations in absence of the safe harbor rule.

Table 2

Corporate Income Tax Receipts under Midsession Review Budget Economic Assumptions With and Without the Effects of the Accelerated Cost Recovery System and Leasing Provisions of the Economic Recovery Tax Act of 1981

($ billions)

	Fiscal Years						
	1980	1981	1982	1983	1984	1985	1986
Corporate income tax receipts under 1980 law	64.6	64.9	72.6	84.4	97.2	109.1	122.9
Economic Recovery Tax Act of 1981:							
Accelerated cost recovery system	--	-1.3	-4.6	-10.2	-17.8	-27.2	-42.2
Leasing	--	-0.5	-2.7	-3.8	-5.4	-7.3	-9.4
Other	--	*	-0.3	0.5	-0.6	-2.3	-2.6
Total	--	-1.8	-7.6	-13.5	-23.9	-36.8	-54.2
Corporate income tax receipts under current law	64.6	63.0	65.0	71.0	73.3	72.3	68.7

Office of the Secretary of the Treasury
Office of Tax Analysis

December 9, 1981

*Less than $50 million.

Note: Details may not add to totals due to rounding.

Mr. GLICKMAN. I will not repeat everything that Mr. Chapoton said, but I would like to reemphasize certain fundamental points about leasing in general, and as it may apply to small business in particular. At the outset, I would like to make it absolutely clear that we stand firm in our conviction that leasing is a necessary part of the President's tax program. We recognize that we have an uphill battle in educating the public on the merits of leasing, and we certainly welcome this opportunity to appear before you today to explain the purpose of the rules and to answer any questions you may have.

As I indicated, the leasing rules are an integral part of the President's tax program to restore economic growth. Every lease is associated with spending for new equipment, and much of this spending would not otherwise occur. The new leasing rules do not make otherwise bad investments into good investments, but they do make good investments equally profitable for companies in different tax situations.

Safe harbor leasing allows all companies, large and small, full access to the incentives in the recent tax bill for making new investment. Without these rules, there will be an unequal competition for funds. New companies will face additional financial barriers, and there will be increased pressure for tax motivated mergers and takeovers. Moreover, as I will discuss hereafter, we expect any additional financial burdens that would arise in the absence of leasing to fall heavily on small business.

To see the need for leasing, the operation of the investment incentives of ERTA must be clearly understood. The principal investment incentive in the new law is provided by the accelerated cost recovery system, known as ACRS. ACRS allows firms to deduct the cost of their investment over a much shorter period of time than before. The acceleration of the deductions effectively lowers the cost of buying new equipment and thereby raises the aftertax rate of return on the investment.

This increase in after tax rate of return is the primary investment incentive of the President's tax program. A problem arises, however, when these accelerated deductions become available at a time when the new equipment is producing little income. In that case, the deductions will serve their purpose only if they can be used to offset other income, other taxable income. If a company does not have other taxable income or cannot transfer the deductions to a firm that is able to use them, the accelerated deductions under ACRS will be postponed, and much of the investment incentive which we are trying to stimulate will be permanently lost.

In any year, many active U.S. corporations are in a position of having no current U.S. tax liability. These include new and young corporations just starting up, companies with particularly large investment plans, and firms with temporary losses but profitable investment opportunities. Additionally, the more rapid writeoffs for cost recovery under ACRS will moderately increase the number of currently nontaxable companies and will also increase the number of companies that will reach the statutory limit on current use of their investment tax credit.

Leasing works thus: As an illustration of how a company may be excluded from the new investment incentives of ACRS, consider a

firm, Newco, making $100,000 investment in equipment. In the first 2 years of that investment, Newco will be allowed to claim deductions under ACRS of $37,000 and an investment tax credit of $10,000. To use all of these benefits, Newco would need to have net income in those 2 years, before ACRS deductions, of approximately $59,000. Even highly profitable investments generally do not return income within 2 years to more than one-half the cost of the investment. Without income from other assets, Newco would have to postpone using some or all of the ACRS benefits, which in turn makes Newco's aftertax return on new investments less than that of its competitors. Stated differently, Newco's return from that investment would be lower than that of a corporation which, for various other reasons and unrelated reasons, may be able to use all the benefits currently.

The essence of the new leasing rules is that ACRS will provide incentives for firms like Newco to invest in new equipment, even though their investments have not yet produced large profits. With leasing, Newco has the option of retaining the ACRS deductions and credits, or it may sell the tax benefits associated with the equipment to another corporation. This allows Newco to use the equipment in its business and, at the same time, permits it to enjoy the benefits of the investment tax credit and accelerated deductions, just as if it had an income from other sources.

There are three important aspects of leasing which must be borne in mind: First, leasing creates no extra deductions or credits. The total deductions and credits taken by both parties to a lease transaction are the same as they would have been if Newco had taxable income from other investments. The Treasury loses no more revenue than those necessary to provide equal investment incentives to all firms, in other words, putting all firms on an even playing field. It might also be noted that an alternative and much less desirable way to accomplish the same result would be by actual merger of Newco with the mature company wishing to reduce its tax liability.

Second, virtually all of the tax benefits of ACRS will be passed through to the company actually making the new investment, in our case, Newco. This is because the purchasing company and other corporations interested in obtaining the investment credit and the ACRS deductions will bid for these by offering favorable lease terms. It is already apparent that the market for the tax benefits is becoming very competitive. From our preliminary analysis of the small sample of sale and leaseback transactions closed in 1981, we have found that about 88 percent of the tax benefits from leased property are being passed through to the lessee. This incentive should increase as safe harbor leases become more routine market transactions.

This is a very important point, because it means that the investment incentive inherent in ACRS remains where it should be; namely, in the hands of the firm that will undertake to make the new investment and employ the new equipment—the lessee. Although the purchasing company claims the credit and the ACRS deduction on its return, it must be kept in mind that it pays for those credits and deductions by paying amounts to the lessee. With

this payment, Newco, the lessee, can ultimately receive virtually all of the tax benefits of ACRS.

The third essential point about the lease transaction is that it does not encourage Newco to undertake an investment unless that investment is expected to be economically profitable. Leasing does not foster uneconomical or tax-motivated investments. Even with the lease agreement, Newco makes a substantial investment in the asset, and the income that the asset generates will be taxed. Unless the asset produces sufficient income, Newco will not be able to make a profit on the investment. Leasing does not guarantee a profit for a bad investment; it merely provides that the same ACRS investment incentives to firms without current taxable income as it provides to firms with taxable income. With those incentives equally applicable, firms are able to select their investment on the basis of their economic profitability, not on the basis of tax circumstances. Thus, quality and efficiency results from the transaction, and in our judgment, this in turn results in economic and sound tax policy.

I would like to visit just a bit with you about leasing in the small business. We are aware that various bills have been introduced to repeal the leasing provisions. We are also mindful of the size of the projected budget deficits and the thought that a repeal of leasing would help to alleviate that deficit. While the repeal of leasing would reduce the revenue in the short run, we believe that in the longer term its repeal would do much to undercut the investment incentives adopted by the Congress last year as part of ERTA. As a result, investments in new plant and equipment would decline with the concomitant reduction in economic activity. If leasing is repealed, we expect much of the impact would fall on small business.

As I mentioned previously, leasing is intended to help those firms which cannot fully utilize the tax benefits associated with new investments in plant and equipment. A typical firm in this capacity would include a new firm or a firm which does not have sufficient income from other assets to absorb the tax benefits. Firms in these categories are usually smaller companies. The ability of these firms to sell their tax benefits is an important source of financing, particularly in these times of tight money and high interest rates. This is especially important for small businesses, because they typically finance their operation from current earnings and borrowings, and tend to rely less on equity types of financing. Thus, in relative terms, the retention and utilization of safe harbor leasing is at least as important to small companies as it is to larger ones. In this connection, while most of the attention on leasing has been on the reported transactions that have thus far been closed between large companies, we do not think that this is indicative of the entire class of companies that have or will benefit from leasing.

We understand from informal discussions with investment bankers and lawyers that because of the November 13 deadline for closing initial transactions and because of the newness of the legislation, many brokers refused to consider small leases. The complexity of the legislation and the transactions made closing costs high and small leases uneconomical. However, we now understand that as the leasing industry becomes more familiar with the rules and the lease documents become more standardized, lease brokers are

turning their attention to small leases. This should make leasing available to all companies on an equal basis.

In addition, the information we have gleaned from the lease information returns, which Congress required to be filed with the Internal Revenue Service by January 31 of this year, indicate that smaller companies have been able to use the leasing rules effectively, even without the aid or assistance of large professional brokers and investment bankers. Of the nearly 16,500 information returns which were filed with the Internal Revenue Service through the end of last week, only 1,217 represent lease deals involving more than $10 million in leased property, and only 859 represent deals involving between $1 million and $10 million of property. Virtually all of the remaining 14,500 leases, or over 85 percent of all safe harbor leases involved property worth less than $100,000, with some as small as a few hundred dollars.

As I noted earlier, our preliminary analysis of the small number of sale and leaseback transactions indicate that about 88 percent of the tax benefits of leased property are being passed through to the user of the equipment who again is the lessee. Although this sample is too small to generalize, it does indicate that the percentage of benefits passed through are about the same, regardless of the size of the lease. Further, the benefits appear to pass through fairly uniformly over the industries.

We have not yet analyzed the data we received on leveraged or straight lease transactions, as contrasted to the sale and leaseback transaction, but we anticipate that the same positive benefit would flow to the user of equipment in these types of transactions which we are finding under a sale and leaseback arrangement. Small companies traditionally are big lessees of typewriters, copying machines, office furniture, automobiles, et cetera. Before safe harbor leasing, the savings realized by these companies through leasing versus buying the equipment depended in large part on the uncertain value of the property at the end of the lease term, which had to be determined under the leasing rules in effect at that point in time. By eliminating the need to take the value of the residuals into account, the safe harbor rules have made leasing more efficient. As a result, less of the benefits of leasing should be siphoned off by the lessor and more should pass through to the lessee users of the equipment.

We are currently analyzing the remaining lease information returns and should be able to provide the subcommittee with additional data on the effectiveness of leasing to small business within the next few weeks. Before concluding my remarks, I would like to comment on one aspect of the leasing regulations that has drawn criticism from some small business groups; namely, the application of the "at risk" rules to the leasing transaction.

As you know, code section 465 limits the amount of the losses that certain closely held corporations may deduct with respect to the activity to the extent of the amount they have at risk in that activity. The concept of at risk was introduced in the Tax Reform Act of 1976. It was basically a measure to restrict tax shelters and provided in essence that a taxpayer could not claim deductions in excess of the amount of cash and recourse debt that he had invested in the activity at the end of any year. At risk has nothing to do

with the calculation of the deductions. It affects the timing of the deductions by matching them dollar for dollar with the taxpayer's actual investment. As this investment increases, the taxpayer is allowed to claim the excess deductions that have been suspended from earlier years when his investment was small.

Individuals, subchapter S corporations, and closely held businesses, and by closely held businesses I am referring to corporations that have five or fewer individuals that own less than 50 percent of the stock, own at least 50 percent of the stock. Individuals, subchapter S corporations, and closely held businesses are subject to the at risk rules. With certain limited exceptions, at risk now applies to all activities, including leasing of depreciable property.

The Economic Recovery Act of 1981 extended the at risk rules to the investment tax credit. Although the at risk amount for the investment tax credit is separate from the at risk amount for ACRS and other deductions, it is similarly measured by the cash and recourse debt with which the property has been financed. Except in the case of subchapter S corporations or personal holding companies, the new leasing rules do not expressly prevent closely held corporations from engaging in leasing transactions. However, the regulations do provide that at risk rules apply to determine the amount of deductions and credits a purchaser of the tax benefits—in other words the lessor—may claim. Because of these rules, many safe harbor lessees or lessors that are subject to the at risk rules will have restrictions placed on the timing of both the ACRS deduction and the investment tax credit that are generated by the lease. This means that some closely held corporations may be effectively excluded from the safe harbor leasing by operation of the at risk rules.

In a speech which was delivered in October by Mr. Chapoton, he indicated that the at risk rules may not apply to closely held lessors in safe harbor leasing transactions. In developing the regulations, however, the Office of Tax Policy concluded that the leasing regulations could not add an exception to the at risk statute without express statutory authority.

Various people representing the small business community have suggested that the leasing provision should be amended to relax the at risk restrictions as they apply to safe harbor leasing transactions. With respect to the application of the at risk rules to the activity of the user of equipment, the lessee again, we would strongly oppose an amendment which would exempt a lessee from at risk if it would otherwise be subject to those rules. Closely held businesses that are lessees should not be able to pass through a fully accelerated effect of ACRS deductions on the lease properties or the full credit in the first year of the lease, if the lessee would have otherwise been precluded from claiming the deduction and credit on its own return. The effect of such an amendment would be to emasculate the at risk rules altogether, and, again, we would oppose that.

A relaxation of the at risk rules as they apply to lessors in leasing transactions, however, involve different considerations. Initially, we question the need for such an amendment.

As I have stated previously, leasing is intended to restore the ACRS and investment tax credit incentives to the lessee by allowing the lessee to sell the tax benefits with respect to the new in-

vestment in the equipment. While it is true that a lessor will presumably earn a positive return from investing in the leasing transaction, that return should be no more than that available in any other type of investment. The real beneficiaries of the new leasing rule are and should be the lessee, that is the user of the equipment who is selling the tax benefit. To that end, closely held companies are not disadvantaged by the regulations, since under the statute, anyone can be a lessee, including an individual. Although the at risk rules are applicable to lessees as well, this should not be a significant problem, since we would expect most lessees, which are small businesses, will be at risk in their investment in any event.

Moreover, any profit earned by the lessor on a leasing transaction is payment to the lessor for advancing the money to the lessee for the ACRS deductions and credits to which the lessee would otherwise be entitled. Effective exclusion of closely held companies as lessors discriminates in favor of large companies only to the extent that large companies have an additional investment opportunity available. It certainly does not mean that closely held companies which were intended to be benefited by the safe harbor leasing rules, in other words the lessee, are denied the benefit of leasing.

It has been suggested that an amendment to ease the at risk rules is needed because small companies will only deal with other small companies. Thus, if small companies are prevented from entering into leasing transactions as purchasers of the tax benefit, many small companies as sellers of those benefits will be unable to take advantage of the leasing provisions.

We question whether there is any natural hesitancy on the part of small companies to deal with large companies in leasing transactions. Moreover, as I have indicated, we fully expect lease brokers will be able to package leasing of equipment to make the leasing of small amounts of equipment attractive to large companies. In addition, which I have also previously stated, the evidence which we have accumulated to date indicates that a substantial amount of small leasing deals are being consummated which would indicate that these are being consummated by smaller companies.

On the other hand, we would agree that since the leasing provisions are market oriented, there is no reason to curtail the universe of potential lessors by discriminating among corporations that are allowed to be lessors. Also, we are satisfied that there are sufficient safeguards within the leasing rules that a change in the at risk rules as they apply to lessors would not open any abuse the at risk rules were intended to prevent. At risk was intended principally to prevent individuals, partnerships, and closely held companies from artificially overstating the depreciation base of their assets through the use of nonrecourse debt. It would not be possible to circumvent this purpose through a leasing transaction as long as a lessee continues to remain at risk. This is because the timing and the amount of the lessor's deductions may not exceed the deduction and credits that would be available to the lessee had the lessee not entered into the lease in the first place.

Although we do have doubts that an amendment to relax the at risk rules as they apply to lessors would have any appreciable effect on the benefit of leasing flowing to small companies, we would not oppose carefully developed legislation along these lines.

However, before giving our final approval to any such amendment, we would want to take a close look at the proposal as there may be special circumstances, with respect to which we would not want the at risk rules modified.

Mr. Chairman, in conclusion, I think it is fair to say that it is not surprising that the celebrated leasing transactions have involved large, well-known corporations. These make the news, but the safe harbor provision is especially important to the growth and continued independence of small business. Small businesses are already using the provision, and many more will benefit from it if Congress does not overreact to the publicity from a few unusual cases.

Mr. Chairman, that concludes my statement, and I will be happy to answer any questions you may have.

[Attachment to Mr. Glickman's testimony follows:]

Form **6793**
(December 19[illegible])
Department of the Treasury
Internal Revenue Service

Safe Harbor Lease Information Return

(Under section 168(f)(8) of the Internal Revenue Code)
For Paperwork Reduction Act Notice, see instructions.

OMB No. 1545-0045
Expires 1-31-83

Part I For Lessor and Lessee

1a Lessor's name	1b Lessee's name
2a Lessor's address (number and street) City or town, State, and ZIP code	2b Lessee's address (number and street) City or town, State, and ZIP code
3a Lessor's employer identification number ▶	3b Lessee's taxpayer identifying number ▶
3c Lessor's principal business activity and principal product or service (see instructions)	3d Lessee's principal business activity and principal product or service (see instructions)
4a Service center where lessor files income tax return	4b Service center where lessee files income tax return
5a Does lessor belong to an affiliated group that files a consolidated return? . . . . . ☐ Yes ☐ No	5b Does lessee belong to an affiliated group that files a consolidated return? . . . . . ☐ Yes ☐ No
5c If "Yes" to 5a, enter parent corporation's name, address, employer identification number, principal business activity, and principal product or service	5d If "Yes" to 5b, enter parent corporation's name, address, employer identification number, principal business activity, and principal product or service

6 Property identification

Property	(i) Brief description (see instructions and group properties by ADR midpoint class life)	(ii) ADR mid-point class life (see inst.)	(iii) Recovery class (see instructions and check applicable column for each property) 3 year	5 year	10 year	15 year real property	15 year public util. property	(iv) Date placed in service (mo., day, year)
A								
B								
C								
D								
E								

7 Date lease term began (month, day, year) ▶

8 Length of lease term, in months and fractions of a month:
a Not including any options to extend . . . . . b Including any options to extend . . . . .

9a Estimated average of lessee's yearly rental payments, for tax purposes, for leases covered by this form . . .
b If rental payments vary according to a formula, give formula by which they are computed ▶

	Yes	No
10a Is the arrangement a sale-leaseback?		
b If "Yes," enter lessor's payment to lessee when lease was made (cash amount or value of other consideration). Exclude lessor's debt to lessee or persons related to lessee		

11 Lessor's debt for the property to lessee or persons related to lessee:
a Term of debt, in months and fractions of a month ▶
b Principal . . . . . c Annual interest rate . . . . . %
d Total interest payment over term of the debt . . . . .
e Method of amortizing principal: ☐ Level-payment mortgage ☐ Straight-line amortization ☐ Other (specify) . . . . .

12 Total paid to third parties to arrange lease (see instructions) . . . . .

	Yes	No
13a Has lessee an option to buy the property at end of lease?		
b Can lessor require lessee to buy the property at end of lease?		
c Is there a fixed contract of purchase binding on both the lessor and lessee?		
d If "Yes" to a, b, or c, enter purchase or sale price		
If amount is not specified, give formula by which it is computed ▶		
e If "No" to a, b, and c, which party will own the property for tax purposes at end of lease? ☐ Lessor ☐ Lessee		
14a Had lessee made an election under section 46(d) regarding qualified progress expenditures for the leased property?		
b If "Yes," how much investment credit was allowable?		

Signature (See instructions):

Lessor's signature _____ Title _____ Date _____

Lessee's signature _____ Title _____ Date _____

For leases made before January 1, 1982, only.—If lessor and lessee do not file original Form 6793 jointly, indicate filer: ☐ Lessor ☐ Lessee

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Part II For Lessor

	Property (refer to line 4)									
	A		B		C		D		E	
15a Lessor's unadjusted basis in the leased property (see instructions)										
b Tentative regular investment credit lessor will claim on property										
c Tentative business energy investment credit lessor will claim on property										
	Yes	No	Yes	No	Yes	No	Yes	No	Yes	No
d Is there (or will there be) an election made under section 48(d) for the lessee to claim the investment tax credit?										

16 Lessor's debt for the property to others than lessee or persons related to lessee:

a Term of debt, in months and fractions of a month

b Principal

c Annual interest rate %

If rate is not specified, give formula by which it is computed ▶

d Total interest payment over term of the debt

e Method of amortizing principal: ☐ Level-payment mortgage ☐ Straight-line amortization ☐ Other (specify) ▶

17a Is lessor a partnership or grantor trust? ☐ Yes ☐ No

b If "Yes," complete the following information for each partner or beneficiary:

Name	Does the partner or beneficiary belong to an affiliated group that files a consolidated return? ☐ Yes ☐ No
Address	If "Yes," complete the following information for the common parent corporation:
Employer identification number	Name
Service center where income tax return is filed	Address
Principal business activity code and principal product or service	Employer identification number
Percentage of ownership or beneficial interest in partnership or trust on date lease was made	Service center where income tax return is filed
	Principal business activity code and principal product or service
Name	Does the partner or beneficiary belong to an affiliated group that files a consolidated return? ☐ Yes ☐ No
Address	If "Yes," complete the following information for the common parent corporation:
Employer identification number	Name
Service center where income tax return is filed	Address
Principal business activity code and principal product or service	Employer identification number
Percentage of ownership or beneficial interest in partnership or trust on date lease was made	Service center where income tax return is filed
	Principal business activity code and principal product or service

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Department of the Treasury
Internal Revenue Service

Instructions for Form 6793

(December 1981)

Safe Harbor Lease Information Return

(Under section 168(f)(8) of the Internal Revenue Code)

(Section references are to the Internal Revenue Code.)

General Instructions

Paperwork Reduction Act Notice.—We ask for this information to carry out the Internal Revenue laws of the United States. We need it to determine whether your lease arrangement meets the legal requirements for the safe harbor lease election under section 168(f)(8). If you want to make the election, you must give us this information.

Purpose.—Form 6793 is an information return about certain arrangements characterized as leases for Federal income tax purposes. The return must be filed for the lease election to be valid.

Filing Form 6793 late or not attaching a copy to the lessor's income tax return will disqualify the election. A lessor or lessee who has reasonable cause for filing the original Form 6793 within a reasonable period after the deadline is considered to have filed it on time.

If you need more information than these instructions give, see section 168(f)(8) and the related regulations.

Filing Form 6793.—Generally, a separate Form 6793 must be filed for each lease. However, one form may cover multiple leases if:

(1) the same lessor and lessee make the leases;

(2) all the leases have the same beginning date and length; and

(3) the same term of the debt and interest rate apply to all properties covered by all the leases, if the lessor has debt with respect to the properties.

If the lease was made before January 1, 1982, an original Form 6793 must be signed and filed by the lessor, the lessee, or both of them jointly. For leases made after 1981, both the lessor and lessee must sign the original and file it jointly. If the lessor or lessee belongs to an affiliated group that joins in filing a consolidated return, the common parent corporation must sign and file Form 6793 on the subsidiary's behalf.

File the original Form 6793 with the Commissioner of Internal Revenue, Washington, D.C. 20224, Attention Form 6793. It must be filed by the later of:

- January 31, 1982; or
- 30 days after the lease is made.

In addition, both the lessor and the lessee must attach a copy of the original form to their income tax returns for the tax year in which the lease begins. For a lessor partnership or trust, a copy of the original Form 6793 must be attached to each partner's or beneficiary's income tax return. (See Specific Instructions for Parts I and II.)

Specific Instructions

If you need more space for any item, attach extra sheets the same size as Form 6793. Show both the lessor's and the lessee's name and identifying number on each sheet, and follow the format on this form. If an item does not apply, enter "N/A."

Parts I and II.—On the original Form 6793 and on the copy filed with the lessor's income tax return, Parts I and II must be completed. Only a copy of Part I, however, needs to be filed with the lessee's income tax return.

Line 3b.—Individual lessees should enter their social security number. All others should enter their employer identification number.

Lines 3c and d.—Trusts that file Form 1041, and individuals, enter the main business activity and product that would be entered on Schedule C (Form 1040). All others enter the principal business activity code and principal product or service that would be entered on their income tax return.

Line 6, col (i).—Give brief descriptions only, and group the properties by ADR midpoint class life.

Line 6, col. (ii).—Enter the property's midpoint class life under the asset depreciation range (ADR), as of January 1, 1981 (without regard to section 167(m)(4)). For ADR class lives, see Rev. Proc. 77–10, 1977–1 C.B. 548 and later revisions.

Line 6, col. (iii).—The property is assigned to one of the following recovery classes. ("Present class life" is defined in section 168(g)(2).)

3-year property is section 1245 property that: has a present class life of 4 years or less; is used in connection with research and experimentation; or is a qualifying horse.

5-year property is section 1245 property that is not assigned to one of the other recovery classes.

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10-year property is section 1250 property that has a present class life of 12.5 years or less; public utility property (except section 1250 property or 3-year property) that has a present class life of more than 18 years and no more than 25 years; railroad tank cars; manufactured homes; or certain qualified coal utilization property (Section 168(h)(4).).

15-year real property is section 1250 property that does not have a present class life of 12.5 years or less.

15-year public utility property is public utility property (except section 1250 property or 3-year property) that has a present class life of more than 25 years.

Line 6, col. (iv).—Property is placed in service when it is ready and available for a specific use. Property that is part of a larger facility under one lease is not placed in service until the whole facility is placed in service. If property was placed in service at various dates, enter the range of dates: for example, 6/1/81—7/31/81.

Line 12.—This item applies only if either the lessor or lessee expects the adjusted basis of the property covered by all safe harbor leases it makes during the calendar year to total more than 1 million dollars. If item 12 applies, enter the sum of the lessor's and the lessee's payments to third parties for arranging this lease. Examples of payments to include are brokerage, legal, and investment banking fees.

Line 13.—If an option to buy or sell the property can be exercised before the lease ends, attach a statement specifying when the option can be exercised during the lease and what the purchase or sale price is. If the price is not fixed, give the formula by which it is computed.

Signature.—Original signatures are required on the original Form 6793, but copies are acceptable on the forms filed with the income tax returns. For leases made before January 1, 1982, the lessor, the lessee, or both must sign Form 6793. If the lease is made after 1981, both the lessor and lessee must sign. The common parent corporation must sign on a subsidiary's behalf. For a corporation, Form 6793 must be signed by the president, vice president, treasurer, assistant treasurer, chief accounting officer, or other corporate officer (such as tax officer) authorized to sign.

Line 15a.—The unadjusted basis means the part of the basis that the taxpayer does not amortize or elect to treat as an expense under section 179.

The basis is determined under part II of subchapter O of chapter 1, without the adjustments described in section 1016(a)(2) and (3). Amortization includes the deduction allowed under section 167(k).

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Mr. NOWAK. Thank you very much. I appreciate your very comprehensive statement, and I think you have cleared up many questions that were floating around, at least as to the definitive position of Treasury today, I think you adequately talked about the at risk problem, and if I am clear, you believe that Treasury is not looking to act administratively to solve any of those problems.

Mr. GLICKMAN. No, sir.

Mr. NOWAK. If a legislative solution is found to be advisable by the committee and Congress, you would take a look at that and, in your opinion, if it added to the solution, you would support it?

Mr. GLICKMAN. Again, Mr. Chairman, if we are talking about relaxing the at risk rules as they apply to the lessor, we would undoubtedly not oppose that in a general context. Again, there may be some special cases out there which could give us some concern if they are too similar to the abuse type of situation which the at risk rules were intended to cover to start off with. But we would not oppose that type of situation. We would, if there was a move afoot to completely release the leasing transaction from the at risk rules as it applies to the lessee. We would oppose that.

Mr. NOWAK. For lessors, you would not oppose?

Mr. GLICKMAN. No, sir.

Mr. NOWAK. You had mentioned in your testimony that 85 percent—I think was the figure you used—of all leasing was property at value less than $100,000. Do you have any figures to date of what total dollar volume that would represent?

Mr. GLICKMAN. Mr. Chairman, we do not have all the figures accumulated as of today. We are still trying to massage the numbers, the returns that we have, but this will be something that I will be more than happy to supply the committee after we have had a little more opportunity to go through this. We are right in the middle of it right now, and what we did was just sort of pull out a random sampling of some of the transactions. I think this would better be handled by another submission on our part when we are a little farther down the line.

Mr. NOWAK. How long would you estimate before we could be able to get that data, because I think it is very important, to see if we can confirm some of the conceptions. I wondered, as the committee started looking at this in greater and greater detail, and we will have to have some reliance on the specific filings this year, is there any date that you could——

Mr. GLICKMAN. Well, the Secretary, in his testimony before both the Senate Finance Committee on Monday and the Ways and Means Committee on Tuesday, or vice versa, I should say, has stated that we would probably have more data available by the middle of March. We will not be ready in the middle of March to have really done a complete analysis of it, but our data will be in better condition at that point in time. So I would hope that by that point in time we will have a better fix on some of the information you are looking for.

Mr. NOWAK. You know, we had a hearing yesterday on the impact of high interest rates, and the devastation that has caused, especially in the small business community. In hearing from certain sectors of the community where unprecedented problems have come up, we find verification of the fact that what we are talking

about is the need for capital formation, and that the sector that really needs some new incentives is the small business community.

I am wondering if your statistical information verifies that the greater percentage of dollar volume is in the very, very large leasing deals. Do you agree that if no progress is made with the at risk rules, another alternative, a corresponding incentive, might be a refundable investment tax credit? This would be in addition to the inclusion of more small deals, and finding a way to have more small businesses take advantage of the leasing. Wouldn't this idea go, to some degree, parallel with what you are trying to do here with the leasing?

Mr. GLICKMAN. Well really, I think that it would be to some degree a redundancy. When we started——

Mr. NOWAK. Well, it wouldn't be a redundancy if you are finding that small corporations, closely held corporations could not take advantage of this provision and there were no brokers out there that were really packaging; then there wouldn't be a reduction.

Mr. GLICKMAN. Well, that's correct. If it turned out that small business was not taking advantage of this in some substantial part, I mean obviously a refundable credit would be a more direct method of getting small business the same amount of dollars. I think from the administration standpoint, Mr. Chairman, when this was developed, the concept of a refundable credit was discussed in some detail, like the concept of transferability, and I think that this administration is going to be very reluctant to recommend a refundable credit. It has, obviously, some philosophical problems with it, but it also has some mechanical problems, some enforcement problems, because what that does is really put the Internal Revenue Service in the decisionmaking process of whether the credit is there or is not there, rather than leaving it to the marketplace to make those determinations.

Mr. NOWAK. I guess what I am saying is, we are going to hear some testimony, and I am sure Treasury is too, in the next few months or weeks of discussion on this topic, that mechanically the small business community is not going to be taking their part in this leasing, and you are going to see pressure building up for some alternative. So if you truly believe this is a more efficient method and mechanically it can be done, we had better get together so that we can accomplish it, or you are going to find other alternatives being looked at, such as the refundable investment tax credit, which many believe would be an answer to this small business portion concern.

Let me go on to my colleagues.

Mr. Dorgan?

He has not had the opportunity to make an opening statement, and Mr. Bedell has. So we will pass on to him, first.

OPENING STATEMENT OF HON. BYRON L. DORGAN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NORTH DAKOTA

Mr. DORGAN. Thank you, Mr. Chairman.

I was interested in your testimony, and let me begin my questioning by telling you that I think this is probably one of the most

outrageous tax provisions ever enacted in the tax law in this country. I have served 10 years in the tax field at the State level, and I worked for a good long while for tax reform and for a fair tax system, and I think this is a giant step backwards. While I sympathize with your position, I think supporting leasing is like being a public relations man for polio. It is a very difficult position for you, because I don't think that there is any good justification, given the market orientation of this administration, for supporting such a leasing provision in the Tax Code.

I guess what I would like to ask is this: If you are a company official who decides you have got to make an investment for your own company's good, to serve a market that you want to serve, why not let the market incentives persuade you to make that investment, exclusive of tax considerations?

Mr. GLICKMAN. That is exactly what we are trying to do, what we think leasing provisions do. I mean, obviously, if taxes are a neutral consideration, as they should be, people ought to make their business decisions on the basis of the economics of the deal as they perceive it.

The problem we see is that if you have two companies out there and they both want to go into the same activity, they are going to buy the exact same piece of equipment. One of them is presently in a taxable position, paying tax someplace else; the other one is not. The return on capital is different between those two companies. The company that does not have an outside source of income is put at a competitive disadvantage to the other company.

We think in that situation that what happens is that taxes do start paying a great deal, playing a real part of the decisionmaking process as to whether the economic investment ought to be made, and thus, we are really trying to do exactly what you are suggesting and take the tax considerations at least to that degree from the standpoint of equity out of the picture.

Mr. DORGAN. Except that I think just the opposite is happening. I think that, at least in part, the decision of what to buy and when to buy it is based on Tax Code considerations. It is staggering to come to town here and talk about these kinds of things without a grin on our face, because the fact is, we are effectively washing away the corporate income tax system. You probably saw the study done by the professor at Illinois recently in which he pointed out that Exxon pays a 1.3-percent income tax on U.S. income. That is staggering; the 20 largest banks don't pay any tax.

I think we are ruining this tax system, and the storm clouds which are gathering over our tax system, which is largely a voluntary system, will one day bring that system down unless the American people feel that we are making some strides toward fairness. We are not making strides toward fairness today; we are making strides away from the fairness issue.

Mr. NOWAK. Would the gentleman yield the point?

Mr. DORGAN. Glad to yield.

Mr. NOWAK. When we look at this, and I am just trying to put this in a total perspective, you are talking about a particular problem here. Now, many have advanced the theory that if the Congress moves ahead with a minimum tax, then that solves this leasing problem. Well, in my view, it wouldn't, because you're still

going to have the same general exclusion of small business that you have now, and a minimum tax may solve a few little separate problems on the other side of this question, but it is not going to solve our problem. I think that is one of the things the gentleman was referring to. So I hope that we look at the institution for minimum tax, which would be a substitute for the inclusion of small business if this provision stays in.

Mr. DORGAN. Do you agree that the preponderance of the benefits of the leasing provision will accrue to the larger corporations?

Mr. GLICKMAN. No, sir.

Mr. DORGAN. You don't?

Mr. GLICKMAN. No.

Mr. DORGAN. Do you have any statistics to demonstrate to us who is gaining the benefit of the leasing provisions?

Mr. GLICKMAN. Well, now, the statistics which I referred to in my testimony would indicate that most of the deals, most of the transactions so far that have been accomplished have been on transactions that have been less than $100,000. I think it is fair to say that the larger companies generally do not go through leasing transactions on smaller amounts of money.

Obviously, we are still going through this information to make sure we do understand it, but to date, I think that our reaction from the statistics that we have seen so far indicates that a great deal of leasing is being done by small business.

Mr. ROEMER. Would you yield on that point?

Mr. DORGAN. I would be glad to yield.

Mr. ROEMER. Let me ask the same question from a different angle and maybe get a dollar figure. What is the tax expenditure? What is the cost to the Treasury of this provision overall, 1983, in your estimate?

Mr. GLICKMAN. When leasing was included in the Economic Recovery Tax Act, the cost of it was, in 1983, $3.8 billion.

Mr. ROEMER. What percentage of that, to get to my colleague's very good question—let's assume that $3.8 billion is correct, which probably is not true, but let's make that assumption. That provision of that tax expenditure accrues to small business?

Mr. GLICKMAN. At this point in time we are not in a position to answer that. I mean, when we made our estimate, the way we make our revenue estimates, it was based upon a variety of factors, including the amount of investment that we visualized was going to be made as a result of ACRS on a macro basis, and it was assumed, out of that portion, how much leasing would be increased based upon that. But at this point in time, I cannot tell you how much of that was attributable to small business, because I don't think we ever came up with the numbers.

Mr. ROEMER. So the answer to my colleague's question is, you don't know.

Mr. GLICKMAN. Mr. Roemer, it seems to me that from the evidence that we have seen to date, if the statistics are correct as to how many of the leases are—the dollar amounts of the leases—in the smaller ranges, and if you move that forward one step and assume that the General Motors of the world do not lease out $50,000 items individually, then you have got to say that a lot of these are going to be attributable to small businesses.

On top of that, the statistics we have looked at so far really only involve the sale and leaseback arrangement. They do not involve what we call the leverage lease arrangement, which is really more attributable to small business than anything else: the typewriters, the cars, the furniture, et cetera.

Mr. DORGAN. The problem is, every incentive that has been put into the Tax Code has been done on the basis that it is good for small business, and yet the combination of those incentives over the years has essentially washed away the tax liabilities of some of the largest corporations in the country at the expense of the small business community. This Tax Code has become a feedlot for the rich, as a matter of fact, and it is fundamentally unfair, and every time we deal within one specific part of the Code, somebody is saying, "That part of the Code was put in there specifically for small business," or "It's terrific for small business," and the larger enterprises are feeding on it. The result is a terribly unfair tax system.

Mr. GLICKMAN. Well, Mr. Dorgan, let me respond by saying that if I said that we put this in for small business, I misspoke. I didn't say that. We put it in to give fulfillment to what we were trying to accomplish through the ACRS system. What we believe is and what statistics we have seen to date indicate is that small business as well as large business is going to be using this type of transaction.

Mr. DORGAN. You are an economist?

Mr. GLICKMAN. No, sir, I am not. I'm a lawyer.

Mr. DORGAN. I'll refrain from all my legal jokes, but I understand your testimony. I understand what you are saying, but don't you, as a representative of the U.S. Treasury, sense some very serious storm clouds brewing over this tax system? What we are doing—the 1981 Tax Act was the most egregious example of unfairness that I have ever seen in tax policy, and it is going to hasten the day when we completely erode the confidence of the American people in this tax system of ours. Don't you sense any problems in that area?

Mr. GLICKMAN. Well, obviously, one of the things that concerns me in my personal capacity and me as my capacity as a representative of the service is the preservation of the tax system. Any time I see anything taking place that I think is going to call into credibility the system, I am concerned. I do think there is a perception out there that the tax system, in many respects, is unfair, and I certainly would not be the one to tell you that it is equitable and efficient in every manner, shape, or form. To the contrary: I mean, it is a very cumbersome provision, and I think it would be incumbent on this Congress at some point in time to try to relieve some of those problems.

However, I think when we start talking about leasing, this is something which, when we got into it, this was a policy that was developed in the Office of Tax Policy. The statements you have read in the paper that say it came from other sources is incorrect; the leasing concept was developed in the Treasury Department. The purpose of it was in essence to take the position that is ACRS was going to accomplish what it was intended to accomplish, that means capital formation and get the economy moving again, that

we had to give full effect to ACRS, and the question then came to our office: How do we do that? How do we do it on an equitable basis so it will apply across the board, and that is how we came to the leasing provision.

Mr. DORGAN. In conclusion, Mr. Chairman, it is a terrible provision in our tax law. If you go back to the fundamentals of our tax system, our tax system is designed to collect revenues from the winners, the economic winners who have made some money, to pay for the cost of government in America. Now we have persuaded the entrepreneurs, the people who are running corporations in this country, to put on green hats and sit in the corner trading tax gimmicks. Winners and losers participate alike in this process, and I really worry about what is going on. This is the most flagrant abuse of the tax system I have seen in decades, and I certainly hope that this Congress moves quickly to correct what was a disastrous 1981 tax bill.

Thank you, Mr. Chairman.

Mr. NOWAK. Thank you. Now we have Buddy Roemer from Louisiana, who has expressed great interest in this topic, along with the interest rate problem, but today I hope we limit our remarks to leasing.

Mr. Roemer?

OPENING STATEMENT OF HON. BUDDY ROEMER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF LOUISIANA

Mr. ROEMER. Thank you, Mr. Chairman. It is always a burden to limit my remarks, but I will try.

I appreciate your being here. I really do. It is nice to talk in person, face to face, about what is a problem. You have already pointed out some dollar problems, the tax expenditure of at least $3.8 billion in a 1983 budget that projects a deficit of at least $91 billion, and small business doesn't need a tax break; it needs an interest break, but due to the chairman, I won't get into that.

You've got here, in reading your testimony, an income transfer policy or an investment transfer policy; call it any other name you want, but that is exactly what it is, and if that is what it is, it is poorly targeted. In fact, it is not targeted at all. In a simple review of the Tax Code in the presentations that I have heard in the last year and a half about increasing savings and investment, that is true; tax reform does that. But where it is poorly targeted, it does it at great cost to the American Government, and one of, I think, the most telling criticisms of this provision in the tax bill is that, although it does provide for some income transfer policy, it does it in a poor way, and it is poorly targeted, and I hope you will review your statement on that basis.

The second point I would like to make is that it is a little bit sad in this administration, which I think the American people have tried to support, as I know I have, to realize now after a year and a quarter that all this talk about a break for small business and economic opportunity comes at a time when the real needs are in terms of some competition in the marketplace, and we hear nothing about competition in the marketplace in terms of monopolistic

attitudes, growth of big business. We hear nothing about that, but we get some poorly targeted income or investment transfer policies.

I am hoping that when you leave this meeting and you rethink the position on this, you can see that our anger is not directed at you or the administration; our concern is directed with an economy that supposedly has its roots in some kind of economic opportunity and economic competition, and, in fact, today's does neither.

This provision is costing the American taxpayers billions of dollars, and I don't think you can prove it is doing one iota for small business. I thank you for coming.

Mr. NOWAK. Thank you very much.

Mr. Bedell?

Mr. BEDELL. Yes. You indicated that everything originated in the Department of Treasury. Is that correct?

Mr. GLICKMAN. That is correct, Mr. Bedell.

Mr. BEDELL. I would like to enter into the record at least one news story that certainly indicates that it did not start there; it started with a group of lobbyists who brought the idea up. At least we can get this in the record so we can determine whether or not we should go by what you say or what they say.

Do you agree?

Mr. GLICKMAN. Could that be entered in the record?

Mr. NOWAK. Let me just take a look so we don't put anything obscene in the record. [Laughter.]

Mr. BEDELL. It was a former Treasury official that is a lobbyist who at least gets the credit from everybody else for this particular item.

Mr. NOWAK. I have no objections, unless others do. I hear no objections, so——

[The information referred to above follows:]

[From the Washington Post, Oct. 5, 1981]

THREE WHO SOWED TAX PROVISION REAP ITS BUSINESS BONANZA

(By Thomas B. Edsall)

A controversial provision in the 1981 tax bill allowing corporations in effect to sell tax breaks they cannot use was engineered in large part by three former Treasury Department officials who now represent companies standing to reap significant shares of the $27 billion bonanza over the next six years.

Their success in winning approval of what amounts to a backdoor federal tax subsidy to unprofitable companies reflects the power exercised by the business community in the development of the administration's $749 billion tax bill.

The new provision permits corporations to enter into lease transactions existing more on paper than in fact—a kind of fiscal netherworld in which businesses with low profits, or none, can "sell" unusable tax credits and depreciation deductions to profitable firms.

The Treasury Department estimates that this one section of the bill will result in lost revenues totaling $27 billion through 1986, although many business executives and lawyers in the field believe the figure will be far higher.

The key figures behind the administration's decision to adopt the provision, each of whom considers it to be an economically sound way of encouraging investment and of spreading the tax breaks evenly in the corporate community, are the following:

Ernest S. Christian Jr., a partner in the lobbying firm of Patton, Boggs and Blow whose clients include the Chrysler Corp., which is already planning to "sell" its tax credits. Christian, legislative counsel for the Treasury in 1973–74 and deputy assistant treasury secretary for tax policy in 1974–75, said he has been working overtime since the passage of the legislation, putting together deals in which low-profit firms

or those running in the red will "lease" investments exceeding $1 billion to profitable companies.

These leases, he said, really amount to the selling of $560 million or more in tax breaks over the next five years, of which $190 million translates into tax breaks for the current year.

Charls E. Walker, of Charls E. Walker Associates, whose status among Washington lobbyists has reached its zenith with the election of President Reagan. Walker, under secretary of the treasury from 1969 to 1972 and deputy secretary of the treasury in 1972 and 1973, includes among his clients such capital-intensive companies as Ford Motor Co., Bethlehem Steel Corp., American Airlines and Trans World Airlines, all of which would be unable to profit fully from the basic elements of the business tax cuts without the ability to "sell" tax breaks.

Frederic W. Hickman, assistant treasury secretary for tax policy from 1972 through 1975. Hickman is widely credited by colleagues with coming up with the basic leasing concept adopted. A partner in the Chicago law firm of Hopkins, Sutter, Mulroy, Davis and Bacon, Hickman said he was putting together deals on a scale similar to that of Christian, about $1 billion.

These three men played critical roles in the leasing tax provision: Hickman producing the idea, Walker and the chief executive officers of his corporate clientele "softening up" Treasury officials reluctant to take a provision that might appear to be a federal subsidy, and Christian nurturing the provision through the complex paths from the Senate Finance Committee to the Senate floor into the House version and finally through the House-Senate conference committee.

The drive to create the new mechanism grew out of the fact that the basic business tax cut was larger and offered more benefits than many companies could use.

The basic cut took the form of a depreciation speedup, allowing companies to depreciate new investments at a rate significantly faster that the actual useful "life" of the machinery, buildings, cars, trucks purchased. But for companies with little or no taxable income these accelerated deductions, along with the existing 10 percent investment tax credit, were of no use: They had no income against which to write off the investments.

Christian said experts knew from the outset that not all companies could take full advantage of this basic tax cut.

Walker, who has been representing a group of companies operating in the red or with only marginal profits—airlines, mines, Ford Motor Co., steel companies—had, as a member of the Reagan task force on taxes, unsuccessfully pressed for a concept of "refundability" to help such companies.

Under refundability, a low- (or no-) profit company that makes an investment would get a direct payment from the federal government in place of the unusable 10 percent tax credit. The idea would not sell in Republican circles, where it looked like a subsidy to companies unable to make it in the free market.

A political strategist of no small will or influence, Walker engineered a meeting in March between the chief executive officers of what had become known in the lobbying world as the "refundability group" and Treasury Secretary Donald T. Regan. The administration was still unwilling to go the route of refundability, but a task force was appointed, ultimately headed by William S. McKee, tax legislative counsel at Treasury.

A key argument Walker and his clients used was that the massive new tax breaks created by the legislation posed the danger of encouraging a breakout of corporate takeovers: profitable companies would find it worthwhile to buy unprofitable companies just to pick up the tax breaks.

EX-TREASURY AIDES PROFIT FROM THEIR HANDIWORK

During this period, Hickman, who shares a number of clients with Walker, began to press for the concept of "leasing" as an alternative to refundability.

Leasing, Hickman suggested, offered a way to create a corporate marketplace in tax shelters without the "emotional excess baggage" of appearing to be federal subsidies. "This was a way to sort of sweep the slate clean," Hickman said.

As an example: an automobile company, hypothetically called Chryford, spends $100 million for new equipment to retool its plants. Chryford has been operating in the red and consequently cannot use the investment tax credit, worth $10 million, or the accelerated depreciation, worth $46 million over five years to a profitable company.

Under the new law, Chryford could within 90 days of buying the equipment, go to a profitable company—a computer or oil company, for example—and in effect "sell" the equipment to the profitable company.

The profitable company has absolutely no interest in owning the equipment, except for the resultant tax advantages. In fact, under the exceptionally loose law governing this transaction, the profitable company does not even have to take legal title to the equipment, just something called "tax title," according to congressional aides. Ownership, property tax liability, responsibility for upkeep, insurance coverage and everything else stays with Chryford.

Using a model developed by Peter K. Nevit, president of Bankamerilease, the "lease" between Chryford and the profitable company could be structured as follows:

The profitable company buys the equipment from Chryford and gives a down payment of $15 million for the equipment, effectively reducing Chryford's purchase cost by that amount. At the end of five years, the profitable company agrees to "sell" the equipment back to Chryford for one cent.

The profitable company would immediately claim the investment tax credit of $10 million and the first year of depreciation, or $6.9 million, for a total tax break of $16.9 million. Chryford would be ahead by $15 million and the profitable company is ahead by $1.9 million.

For the next five years—the accelerated-depreciation period for the equipment—the profitable company would "pay" Chryford annual payments of $25,356,820 (principal and interest at 15 percent on the $100 million) and Chryford would pay a "rental" or "lease" fee back to the profitable company of exactly the same amount. These payments would cancel each other.

Until the last of the five years, the profitable company would be able to deduct depreciation on the equipment, reducing its tax liability by a total of $10,143,200 over four years. The profitable company would owe this same amount to the federal government as a tax liability in the fifth year, but the money for those four years would function as the equivalent of an interest-free loan of $10,143,200.

In sum, Chryford gets to buy the equipment at a $15 million discount, and the profitable company gets $1.6 million out front and a four-year interest-free loan totaling $10,143,200.

Asked about his interest in the provision at this point, Christian said that until the concept was adopted by Treasury he had no clients with a direct interest in leasing as a way of shifting tax benefits.

But soon after the approach was accepted, "it was at that stage that I had from then on a very substantial interest in the matter and spent a lot of time working on the subject," he said.

Christian contends that the leasing provisions of the 1981 tax bill are "marvelous" and will emerge as "one of the most important developments in the tax law."

As for providing the legal work for lease arrangements, he said, "In one form or another, I'm probably involved in close to a billion dollars. . . . I've been working hard, that's all I can tell you."

Hickman said he had picked up about the same amount of business. "I think that our office and Christian's office, because of the fact that we were involved in the genesis of the thing, . . . undoubtedly [we are] heavier in it than the normal office."

Mr. BEDELL. The information we have indicates that 80 percent of the jobs are created by small business, 43 percent of our gross national product, 70 percent of our payroll, and 79 percent of our employment. Would you question those figures?

Mr. GLICKMAN. I don't know whether they are correct or not. If you say that that's what the statistics indicate, I wouldn't——

Mr. BEDELL. It sounds reasonable, doesn't it? In your figures, in regard to the leasing provision—taking your figures, not going by what anybody else says, but taking your figures—you said that there are 1,217 leases involving deals of more than $10 million in leased property. This is on page 5, at the bottom of your testimony. Is that correct?

Mr. GLICKMAN. Yes, sir, that's correct.

Mr. BEDELL. That would mean, if you take 1,217 times $10 million, what would you come up with, Mr. Glickman? $12 billion, right?

Mr. GLICKMAN. Yes.

Mr. BEDELL. That would be the least that that could be, because they were all at least that large. Is that correct?

Mr. GLICKMAN. Yes, sir.

Mr. BEDELL. Then if we take your next figure here in which you talk about the 85 percent and in which you say, "Virtually all of the remaining 14,500 leases or over 85 percent of all safe harbor leases involve property worth less than $100,000, with some as small as a few hundred dollars." If you take $100,000 times 14,500, what would you get? Well, it's $1.4 billion, I will tell you. That would be the most that could possibly be, because you are taking the highest figure there, are you not?

Mr. GLICKMAN. Yes, sir.

Mr. BEDELL. So taking your figures, if we take your figures, the big corporations get at least $12 billion. Small business, which makes up 80 percent of our new job offers, gets, at the very most, $1.4 billion, or roughly 10 percent.

I don't understand how you can sit there and say that this is something that is going to be great for small business, when according to your own figures, it is just exactly the opposite, and at least this Congressman questions very much whether the 85 percent of those people that you claim are even small businesses, because we can't even find hardly any small businesses that can do it. There may be big businesses that are making leases for $100,000 I don't know; but sure as heck, any way you skew these figures in your benefit, it shows that it is just absolutely 100 percent a big business deal, and I don't see how you can sit there legitimately and say that the preponderance will not accrue to large businesses when your figures clearly prove exactly that they do. What is wrong with your figures?

Mr. GLICKMAN. Well, several things. First, I disagree with what you are saying.

Mr. BEDELL. Don't disagree with what I am saying; disagree within the figures we've got here; show us how they are wrong.

Mr. GLICKMAN. Mr. Bedell, the figures are empirical information that we are getting from what taxpayers send us in. They are purely numbers of returns that are coming into us. As of right now, we have not gotten down to the point of talking about dollars with them. Now, with respect to——

Mr. BEDELL. You listed dollars in your figure. You are the one that listed dollars, sir.

Mr. GLICKMAN. But this is talking about the size of the deal. What you are really saying is that capital-intensive industries, most of them are not in the smaller businesses; most of them are in the bigger, and larger businesses, but ACRS is founded on the concept——

Mr. BEDELL. But you said the preponderance will not accrue to large corporations. You didn't say whether they got a lot of money or not. You said it would not accrue to large corporations, and yet your figures clearly show it will.

I don't want to take time; we're short. I think the public should realize what the situation is. The situation is that big business put the President in office; big business put a lot of money into that campaign. Big business was too darn greedy when it came to the tax law. Big business worked with the Department of Treasury and

wrote some tax laws which are absolutely wrecking the economy. Somebody better face up to that, and somebody better face realistic figures and not try to give us a whole lot of hogwash, when the figures clearly show that this is a big business deal, put in for big business, to help big business, does nothing for small business, and then you sit here and say that that's the benefit of it.

I am sorry to get so upset, but if you are an American citizen, I don't see how you can sit here and not get upset over what is happening to our society here today, due to the greed of big business and what has happened in our political system. Thank you, Mr. Chairman.

Mr. ROEMER. Mr. Chairman, could we record Berkley as doubtful? [Laughter.]

Mr. NOWAK. We will take judicial notice of that.

Let me once again emphasize the need for the breakdown of this type of information. The conclusion that has been reached by many is, very emphatically, that this has been of benefit between two large corporations, and the small business community is aware of these statistics, and has been planning to look at this total posture. I think this is the first opportunity they have of expression, and I think you will find more and more small business persons speaking out. I hope that we can get that statistical information both in the numbers and size of corporations that use it and in terms of the exact dollar volume of each transaction and complete analysis of it.

Mr. BEDELL. Mr. Chairman?

Mr. NOWAK. Yes?

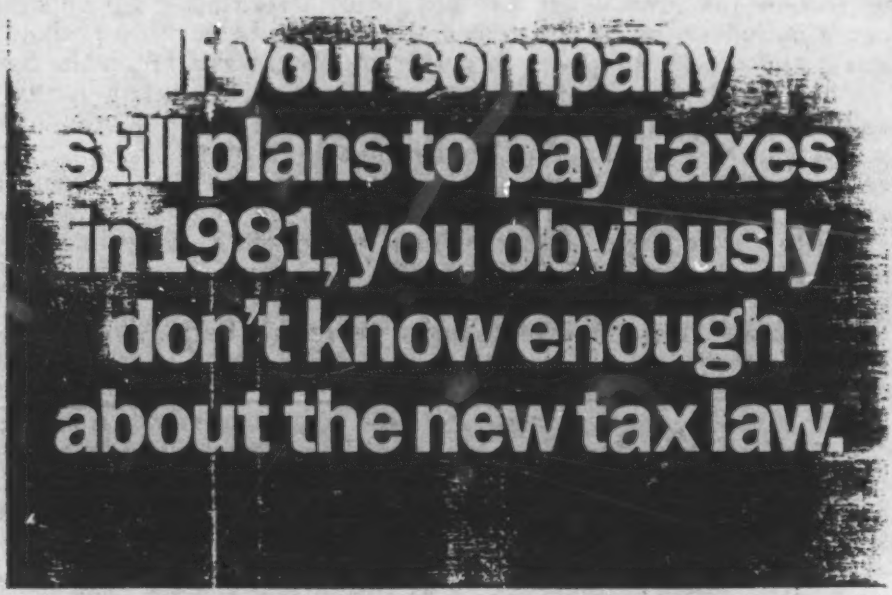
Mr. BEDELL. Could I ask that another item be entered into the record? This was an ad that was in the Wall Street Journal, headed, "If your company still plans to pay taxes in 1981, you obviously don't know enough about the new tax law," put in by the Arbour Leasing Co.

Mr. NOWAK. I assume that this is a packager of leasing.

Mr. BEDELL. That is correct.

Mr. NOWAK. I don't know if our report will be read that widely that everybody will take advantage of it because of this ad, but I don't see any harm in it. Without objection, we will put it in.

[The information referred to follows:]



The new tax law allows your company to benefit from the substantial credits and deferrals offered by equipment leasing, with the assurance that the tax savings will be unchallengeable.

By creating a "safe harbor" the law has eliminated any risk of using equipment leasing as a tax savings device. That's why the largest U.S. banks and corporations are now aggressively acquiring equipment leases.

Why shouldn't you? If your company is planning to pay over $100,000 in 1981 federal taxes, there has never been a better time to talk to us about our equipment leasing program.

Let us put the law to work for you. We have the experience and resources to tailor a program to meet your company's specific needs.

If you want to learn more about why the new tax bill makes such interesting reading, call or write.

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488 Madison Avenue
New York, NY 10022 (212) 371-8868

from the Wall Street Journal - October 30, 1981

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Mr. BEDELL. Thank you.

Mr. NOWAK. Mr. Centner?

Mr. CENTNER. How do you define the small business community?

Mr. GLICKMAN. That is, obviously, a very difficult question. I am not sure how this committee defines it.

Mr. CENTNER. We know how we do it. How do you do it in Treasury? You come in and make a point that a particular tax provision is beneficial to small business; on what basis do you do that?

Mr. GLICKMAN. It is really—it is sort of a different definition for every issue. You can go through the Internal Revenue Code. There is obviously a variety of different provisions as to what is and what is not small business.

Mr. CENTNER. I know. That is where we get our figures, from the code. That is why I am interested in whether you know——

Mr. GLICKMAN. But even in the code it is not consistent as to what is and what is not a small business. We have met with a variety of groups over the years trying to determine what is a definition, and we can't even get agreement on that. So we have seen it based on the value of assets, gross receipts, gross sales, number of shareholders. We have seen it based upon a variety of factors. So I think it is clear it is sort of a nebulous definition, what different people think about it.

Mr. CENTNER. When you come up here and talk about something good for the small business community, then you are talking about something that is good for a group of which you have no good definition. Is that what you are saying?

Mr. GLICKMAN. No; I think there would be an area that we would all sit and agree is small business. I think there is an area which everyone would agree is not small business, and I think undoubtedly there is an area in between there. I think that when we look at the transactions as we see them, as they are coming through right now, and again I want to make it clear that the information we are working from is brand new. We have just gotten our hands on it within the last 2 weeks or so. Maybe it is even shorter than that; so it is really very, very recent information. But from what we can tell so far, at least our reaction is that a lot of the deals we are seeing are small enough that under anybody's definition they would have to be a small business that was doing it. We have seen some leases come through where people are leasing $200 and $300 type of transactions.

Mr. CENTNER. Well, let me ask the question a different way then. What percentage of the people filing business tax returns are sole proprietorships, closely held, or subchapter S and therefore subject to the at-risk rule?

Mr. GLICKMAN. I don't know the answer.

Mr. CENTNER. We would appreciate it if you would get that for Mr. Marriott, and also find out how many people filing individual tax returns are small businesses that can, or cannot take advantage of the leaseback provisions.

Mr. GLICKMAN. Would you state that question again?

Mr. CENTNER. What percentage of those filing business tax returns are closely held, subchapter S, sole proprietorships? What percentage of those filing individual returns, which as you may or

may not know comprises the majority of small businesses in the country, can use the provisions of the safe harbor leasing?

Mr. GLICKMAN. I can answer the last question for you; 100 percent of the businesses can use the safe harbor leasing provisions, whether they are sole proprietorships, whether they are subchapter S corporations, whether they are partnerships or what. Anybody, any lessee can use the safe harbor leasing provision, so that the type of entity we are trying to give the benefit to, the entity that is going to buy and use the equipment, there is no limitation on their ability to use the safe harbor leasing. I can break down these other statistics for you.

Mr. CENTNER. Would you, please?

Mr. GLICKMAN. Sure.

Mr. DORGAN. Would the gentleman yield, just for a moment? Your point about the definition of small businesses is right on target. Last year was the first time in my life that I heard the term the "Ma and Pa Multinational Oil Company." I think by the question you asked, you were trying to get at their definition. Is that a small business? Who are you trying to benefit here in the business sector when you are talking about small versus big business? I am not sure there is a very clear definition. I think Mr. Bedell is right on point. I think it is clear what these tax laws are designed to do. They are designed by architects of our tax laws to reward an economic sector in this country that is the least productive.

I do want to mention that Mr. Roemer, I think, would not want to speak for me in saying that I am not angry, either, at you or the administration. I am certainly not angry at you, but I am angry at any administration that has architects of these kinds of tax laws working in the administration.

Mr. NOWAK. Thank you very much.

I think you can tell, at least by the general tone, that we have some disagreement as to the effect and really what the consequence of this will be and the effect on small business. You know, many feel that, once again, the small business community is being singled out really to bear the tax burdens of the total business community, when at the same time, because of interest rates and other problems, the small business community is in need of the greatest of tax relief. So there will be further testimony today, and I hope that you will be able to take this concern back and be able to express this to Mr. Chapoton and others there and, Mr. Glickman, be able to work with us as we try to analyze the impact so that we can improve the equity of this situation.

I want to, again, thank you very much for taking the time and for preparing as much analysis as you could with the statistical information you had, with the caveat that we would like more.

Mr. GLICKMAN. Thank you, Mr. Chairman.

Mr. NOWAK. Thank you very much.

Unfortunately, there is another request for this room at a later time today, and we are going to have to move ahead a little more expeditiously than we had planned, but I still want to get in all the detail that is necessary in looking at the statements. Many are very comprehensive and complete. So what we would like to do now is have two panels come forward with the testimony, and if you will just take seats across, I think we have enough mikes so we

can ask joint questions, because I think they overlap to a great degree.

We would like the Smaller Business Association of New England to come forward, Charles Kennedy. Mr. Kennedy is a tax accountant with the Boston office of Price Waterhouse, and he is accompanied by Stuart Baird, Jr., president of Leasemakers, of Wellesley, Mass. Mr. Baird is an associate of the Federal tax committee of SBANE. His firm is involved with lease brokerage and consulting for manufacturers and distributors of equipment.

Also joining this group on the panel is the American Institute of Certified Public Accountants, with Gerald Padwe, who is a CPA and a member of the Federal Tax Division of AICPA. He is an associate of the national director of taxation of Touche Ross & Co.; and the other very highly qualified attorney who has been involved in this area is Mr. Leonard Kriss who is a partner from Diebold, Millonzi, Raiser, and Robshaw. He will be accompanied by his colleague, Robert Portin, who has a law firm both in the Washington, D.C. area as well as Buffalo, N.Y.

So gentlemen, we want to welcome all of you here. Certainly, whatever you present I am sure will be widely distributed, especially within Treasury who will keep people here to not only take your testimony, but listen to the development of colloquies as we go along. So I want to welcome each of you and in advance thank you for taking the time to prepare your testimony which, as I have said, is very extensive and complete. All of your testimony will be inserted in the record in its full text, and if you would desire to summarize your testimonies, we will then have the opportunity to establish any more detail through colloquy.

Mr. Kennedy, if you would like to start, then we will move to Mr. Padwe, and then Mr. Kriss.

PANEL CONSISTING OF CHARLES KENNEDY; STUART BAIRD, JR.; GERALD PADWE; AND LEONARD KRISS

TESTIMONY OF CHARLES S. KENNEDY, CPA, PRICE WATERHOUSE, AND STUART BAIRD, JR., PRESIDENT, LEASEMAKERS, BOSTON, MASS., REPRESENTING THE SMALLER BUSINESS ASSOCIATION OF NEW ENGLAND

Mr. KENNEDY. Thank you, Mr. Chairman.

As you mentioned, I am with Price Waterhouse in Boston. I work with our firm's small business tax practice. Accompanying me is Mr. Stuart Baird, the President of Leasemakers, which is a counseling and brokerage service for equipment leasing in Boston.

I am speaking to you today on behalf of SBANE, which is a small business organization which represents the regional coalition of businesspersons and their concerns.

I would like to address my comments toward the issue of safe harbor leasing as part of the Economic Recovery Tax Act. I think we are all well aware of the fact that leasing rules are an essential part of President Reagan's tax program to encourage economic growth and that safe harbor leasing was enacted as a means of assuring that the investment stimulus of accelerated cost recovery and investment tax credit would be made available equally to all

eligible parties making new investments, whether or not the investment party has significant current income.

Secretary of the Treasury Regan, in an interview with David Brinkley, said that the original design of safe harbor leasing was to help companies in formation with no income against which to offset tax credits. He further stated that by allowing the benefits to be used currently via sale, the company receives cashflow, becomes more productive, invests in more capital formation, and so on.

We agree with the underlying premise that these leasing transactions will provide significant help to companies who may otherwise be unable to fully utilize the provisions of the act. Our belief that safe harbor leasing embodies sound principles is evidenced by several observations: The tax benefits are passed through to the firm actually making the investment; the total deductions and tax credits created remain unchanged in amount; and only economically profitable investment decisions will be made. The committee reports, which I am certain you are familiar with, implicitly suggest that the financial leasing industry be deregulated by virtue of the elimination of certain tax rules and regulations.

The Assistant Secretary of the Treasury, John Chapoton's oft-quoted speech in October, affirmed the intent when he said, and I quote, "Because ACRS and the increased investment tax credit create additional deductions and credits . . . leasing is even more important to make sure that the incentives Congress passed will be used."

He also indicated that the seller of property in a transaction would not transfer any more credits or ACRS deductions than it otherwise would have been entitled to claim, taking into account the at-risk rules of the Internal Revenue Code. He went on to say that a purchaser of those tax benefits, under a safe harbor lease, would not be limited by those rules from claiming the credits and deductions that would have been available to the lessee.

Unfortunately, the temporary regulations don't follow through with that intent; rather, they limit the credits and deductions with respect to the leased property for closely held companies engaged in active trades or businesses. This distinction between closely held corporations and other corporations we feel discriminates against the closely held corporations by requiring that they maintain the significantly higher at-risk posture to qualify for a safe harbor lease. By virtue of the fact that the leasing rules have incorporated by reference rules which were designed to prevent abuse in tax shelters, small businesses are denied opportunities which occur from participating in safe harbor leasing transactions.

Therefore, we would like to suggest that an amendment be considered to remove this inequity for closely held corporations and clarify the original congressional intent.

Another burden to the small businessperson under the safe harbor leasing rules is the harsh result incurred upon disqualification of the lessor. The Treasury's temporary regulations interpret a qualified lessor to include a partnership all of whose partners are corporations other than so-called subchapter S corporations or personal holding companies. This in and of itself we believe to benefit our constituency because it allows for small corporations to achieve synergism in a partnership where it would individually be lacking

the capital to effectuate a leasing transaction. But the temporary regulation goes on to state that if at any time during the lease term a partner ceases to be a qualified corporation, the entire partnership entity shall cease to qualify. We believe that this is unfair to the surviving partners and that there should be a provision which allows for a substitute of the no longer qualified partner or for the remaining partners to continue without terminating the partnership.

A related issue of concern to the small businessperson is the exclusion of certain noncorporate taxpayers from the definition of "qualified lessor." Why should a sole proprietorship be denied the advantages obtainable by a corporation? We believe that an individual carrying on a bonafide business should have parity with his corporate competitor in regard to leasing. An individual proprietor who, for example, satisfies the standard under the research and development provisions in the Internal Revenue Code of "carrying on a trade or business" is obviously not going to be in a lease transaction for pure tax avoidance purposes. We bring this matter to your attention and hope that you will consider some way of allowing all small businesspersons to share equally in the benefits of safe harbor leasing.

There is an example attached to the printed text of my testimony, which serves to point up the economic viability of the sale leaseback transaction. I don't think it is important to go into that example at this time.

It has been shown in many ways by many people that the benefits of this election to the seller outweigh the advantages of retaining the investment tax credit and ACRS deductions for businesses currently in a loss position or with other substantial tax credits.

The message that we would like you to take with you is that the small business person is being precluded from taking the same advantage of safe harbor leasing rules as larger corporations and that this apparently was not the intent of Congress in the original legislation but is being regulated by the Treasury Department. Small business needs this potential infusion of capital just as much as big business, maybe more.

Mr. Baird will now present his remarks about the marketplace within which small business persons will execute safe harbor leasing transactions.

Mr. NOWAK. Thank you very much, and we want to welcome Mr. Baird who is certainly a good addition to our inquiry here today, because he is one who was actually involved in the detailed workings of a lease and has been involved in the packaging in this area. So we want to especially welcome you before the committee, Mr. Baird.

Mr. BAIRD. Thank you very much Mr. Chairman.

From a political standpoint, since I have learned so much here today, I hope everybody is listening as I now include big business for a moment in the definition of closely held company, because to date, I don't think this point has been made clear, and I have a letter here today from a Massachusetts company that has 117 stores, 500 employees, that seeks to do an $8 to $10 million transaction, but they are closely held, and so they would be at risk for 100 percent, and this I find incomprehensible.

Let's assume, however, that you do accomplish SBANE's recommended modifications, which Mr. Kennedy has presented. What, then, is in store for smaller businesses? Contrary to the presentation of the Treasury representative, which was very interesting, my discussions since October 1981 with numerous tax accountants, smaller businessmen, established economic lessors, is that those who have been doing leasing for some time, and potential tax benefit transfer buyer lessors, confirmed a number of matters as being the reason why a smaller company interest in this type of business has been quite negligible to date.

First of all, most smaller businesses are closely held and thereby perceived as less attractive to tax benefit transfer lessors, obviously due to the 100 percent at-risk requirement.

The second point is that the Treasury regulations are incomplete as of the moment. They are already clearly counter to generally perceived congressional intent, and, thereby, a great deal of uncertainty has been created, not to mention whether States are going to follow through and follow the Federal lead here or not. Lastly, but quite importantly, the financial accounting regulations which are going to result.

There is still confusion over the effects of the at-risk provisions, particularly on lessors which do business with closely held lessees. One that I spoke earlier this week is one of the largest companies doing this kind of business and did not understand that they would have to be 100 percent at risk for closely held corporations. I found this again quite surprising.

Unfortunately, most of the press has left, so this comment will go largely past them, but the huge, publicly reported transactions certainly produced an "I'm too small" feeling on the part of a small businessman, and this, with the lack of an active market and a concern over the cost benefit of safe harbor leasing due to high legal and accounting costs, certainly also accounted for the observation that I found that very little of this business had been done.

As an indication of that, here is an editorial from the Boston Globe back in November headed "Back Door Tax Breaks." Actually, there was a fair amount of public relations value came out of this kind of reporting in terms of emphasis on loss provisions. The Treasury, I think, has made quite clear here this morning that we are not really talking about a loss in the sense that if I have a dollar and I lose it, it is gone forever, but rather a deferral, which may be no less important in terms of our budget deficit situation at the moment. However, when most people hear the word "loss," they think something different.

Other reasons for the lack of small businesses leasing business is certainly there has been a general reduction in the amount of capital equipment acquisitions, due to poor business prospects and the high cost of money, and point six, knowledgeable intermediaries who are experienced in leasing have been reluctant to, so far, get substantially involved due to the many uncertainties and risks that remain.

Now, in July, the changes in the safe harbor leasing provisions came up quite suddenly without hearings, and we got into, as I earlier alluded to, the media coverage which has developed a fair amount of negative public response, and that was the last reason,

No. 7. Thus, the recognition, really, the safe harbor leasing proceeds, the cash that the seller gets for selling his tax benefits, sustain jobs and help U.S. taxpayers by increasing available cash is often overshadowed by feelings of anger and guilt, even, I might add, among tax benefit transfer buyers.

Now, without these impediments, most people that I interviewed feel that there is significant latent demand for safe harbor leasing and that it will appeal to smaller business and that this will increase the supply and availability of such service. The president of one large bank leasing company, which had started out doing only multimillion dollar safe harbor leases initially as a broker and then for its own account, said that he found the business increasingly attractive granted the recommended changes are made. He would gladly pool and sell $100,000 leases, whereas he currently feels that a single $100,000 transaction is too small. Now, such a professional lessor, I might add, adds substance and accountability to the transactions by providing 100-percent financing, even if borrowed from the lessee, plus systematized, audited reporting. Tighter credit evaluation would reduce the amount of safe harbor leasing done, and, hence, the Government revenue deferral, not loss. Requiring management of tax benefit transfer leasing through a professional lessor would permit reporting of less burdensome detail. For example, question three on IRS form 6793 is "a description of each individual property."

Yesterday in the Wall Street Journal it was reported that IRS is now using random samples of company records to try to reduce the amount of paperwork and detail that they get into and for such items as investment credit. So this recommendation would seem to be reasonably timely.

Now, $100,000 is the minimum size also for another large economic lessor who felt that "Until others develop and advertise interest in smaller leases, safe harbor leasing cannot be fairly judged."

The leasing trade association, the American Association of Equipment Lessors, in a recent news bulletin, reported that marketing is the greatest uncertainty. "Several of the economic leasing companies," the professional leasing companies, "are developing new lease products for safe harbor lease treatment. They focus on smaller sized deals, because the area is relatively free of tax benefit transfer competition and one in which lessors are more willing to give nominal purchase options."

I talked yesterday with a life insurance lessor; one of the largest. They are currently doing transactions as small as $75,000, and another large bank is doing $50,000 transactions. So I think what we can see is already, even with the impediments, there has been some motion in the direction that you gentlemen would like to see, I am sure.

Now, how about under $100,000 or under $50,000? In this area, really manufacturers and distributors of equipment already lease more of the smallest items because they are really best situated to provide this service economically. They are already calling on customers, they process documents, and they service equipment. For example, a well-known truck company advertises rentals here, not too long ago, on trucks at under 8 percent equivalent interest, just

at a time when the prime rate is 16 to 17 percent. This is really how the benefits are most likely to reach the smallest lessees, rather than through a cash payment, just the practicality of it.

Unfortunately, few of the manufacturers and distributors that I have talked with over the years who were not already involved with leasing understand and know how to use it well, regardless of whether they are self-financed or whether they use third-party financing, and thus creating the incentive of clear equality on a tax basis with other safe harbor lessors, which I encourage the committee to consider.

At the present time, a manufacturer lessor must put on his books at cost rather than selling price equipment, and I would welcome a question on this point later.

I would like to just close with the observation that as the actual Treasury figures on tax benefit transfer leasing through December are released, I think there are two realities to be borne in mind which will tend to overstate the figures: One was brought up by this large bank that I spoke with yesterday, and that is that at the last moment, on many larger transactions last year, they decided to qualify an already existing transaction according to the safe harbor leasing rules, just obviously for safety reasons. These figures had to be reported, and they will be part of the figures which Treasury puts forward, which is to say, point 1, why the Treasury figures are going to be somewhat overstated.

Lastly, the expensive handicaps that everyone has had to function with here like the uncertainty of the regulations not being completed yet—which means very high legal costs—leads me to feel that there are meaningful cost reductions which you will be able to facilitate by influencing safe harbor leasing provisions as suggested in these statements.

Thank you.

[Attachment to Mr. Baird's testimony follows:]

CHART I.—COMPARISON OF SELLER POSITION, RETAIN VERSUS SAFE HARBOR SLB[1]

	Sale of ACRS and ITC benefits (after-tax cash flow)	Retain ACRS and ITC benefits (after-tax cash flow)
1981	360,000	0
1982	0	0
1983	0	0
1984	0	0
1985	597,670	1,120,000
1986	156,730	0
Total	1,114,400	1,120,000
P.V. at 15 percent	780,785	640,363
P.V. at 9 percent	886,685	793,436

[1] Hahn, "Transferring Deductions and Credits Under the Economic Recovery Tax Act of 1981—The Special Rule For Leases," Taxes, December 1981.

CHART II.—SELLER AFTER-TAX CASH FLOW [1]

	Cash received	Debt service received		Rent payment (2+3)	Net tax deduction (4−2)	Unutilized deductions (cumulative)	After-tax benefit of utilization of deductions	Total after-tax cash flow (1+7)
		Interest income	Principal					
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
1981	360,000	69,700	53,660	(123,360)	53,660	53,660	0	360,000
1982	0	255,004	238,438	(493,442)	238,438	292,098	0	0
1983	0	211,812	281,630	(493,442)	281,630	573,728	0	0
1984	0	160,794	332,648	(493,442)	332,648	906,376	0	0
1985	0	100,536	392,906	(493,442)	392,906	0	[2] 597,670	597,670
1986	0	29,362	340,718	(370,080)	340,718	0	156,730	156,730
Total	360,000	827,208	1,640,000	(2,467,208)	1,640,000	.....	754,400	1,114,400

[1] Hahn, "Transferring Deductions and Credits Under the Economic Recovery Tax Act of 1981—The Special Rule For Leases," Taxes, December 1981.

[2] 46 percent of cumulative unutilized deductions plus 1985 deduction.

CHART III.—BUYER AFTER-TAX CASH FLOW [1]

	Initial payment	ACRS allowances	After-tax allowances (46 percent of 2)	Investment tax credit	Rental received	Debt service paid		Taxable net income	Taxes owing (46 percent of 8)	After-tax cash flow (1+3+4+9)
						Interest expense	Principal			
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
1981	(360,000)	300,000	138,000	200,000	123,360	(69,700)	(53,660)	53,660	(24,684)	(46,684)
1982	0	440,000	202,400	.....	493,442	(255,004)	(238,438)	238,438	(109,682)	92,718
1983	0	420,000	193,200	.....	493,442	(211,812)	(281,630)	281,630	(129,550)	63,650
1984	0	420,000	193,200	.....	493,442	(160,794)	(332,648)	332,648	(153,018)	40,182
1985	0	420,000	193,200	.....	493,442	(100,536)	(392,906)	392,906	(180,736)	12,464
1986	0	0	0	.....	370,080	(29,362)	(340,718)	340,718	(156,730)	(156,730)
Total	(360,000)	2,000,000	920,000	200,000	2,467,208	(827,208)	(1,640,000)	1,640,000	(754,400)	5,600

[1] Hahn, "Transferring Deductions and Credits Under the Economic Recovery Tax Act of 1981—The Special Rule For Leases," Taxes, December 1981.

Mr. NOWAK. Thank you very much. We will have Mr. Padwe's testimony now. Again, he is a certified public accountant and a member of the Federal tax division of the American Institute of CPA's. He is associate national director of tax services for Touche Ross & Co.

Welcome, Mr. Padwe.

TESTIMONY OF GERALD W. PADWE, CPA, FEDERAL TAX DIVISION, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Mr. PADWE. Mr. Chairman, thank you very much. Members of the subcommittee, good morning.

My name is Gerald W. Padwe. I am appearing before you today as a representative of the Federal Tax Division of the American Institute of CPA's. The AICPA nationally represents about 175,000 certified public accountants, many of whom spend a substantial portion of their time dealing with Federal income tax matters and most of whom spend at least part of their time dealing with problems of small business.

On behalf of the institute, we appreciate the opportunity and invitation to appear before you today.

The Federal tax division has submitted to you a technical paper, which you will be happy to know I do not plan to discuss with you in detail, and earlier this week we submitted extensive comments to the Treasury Department on the temporary safe harbor leasing regulations.

Mr. NOWAK. Excuse me; the paper that you submitted to Treasury, is that in variance with our submission here today?

Mr. PADWE. It is even more detailed in terms of technicality, and we would be happy to have a copy of that submitted to you, sir, for the record.

Mr. NOWAK. I would hope you would give us that for the record.

Mr. PADWE. We certainly will.

Mr. NOWAK. Thank you.

Mr. PADWE. What I would like to do with you today, though, is to summarize and highlight a couple of the technical issues which concern us as to the ability of smaller businesses to compete for the opportunity to use the safe harbor leases as lessors. The principal technical problem and it was alluded to by Mr. Glickman earlier this morning for small business concerns the extension of the at-risk rules under the investment tax credit provisions of the Internal Revenue Code to lessors, as well as the ACRS provisions.

It is our position that the regulatory extension to lessors contradicts legislative intent, may well lack statutory authority, and, in particular implies that small business, by and large, cannot compete to acquire tax benefits under the safe harbor lease rules.

The legislative intent, I believe, is pretty clearly shown if you just look at the progress of the statute. The Senate version of the 1981 Economic Recovery Tax Act—ERTA if I may—stated that corporations owned by five or fewer shareholders could not be lessors for safe harbor leasing purposes. The House version of the bill—the one with respect to this provision that finally passed provided, and this is now in the statute, that personal holding companies could

not be lessors. That is to say, companies 50 percent owned by five or fewer shareholders and having essentially passive income. In other words, closely held companies, per the statute, in an active trade or business, could be lessors.

Now, how do the regulations affect this particular provision? The temporary regs state that the lessor is limited, as to safe harbor benefits, to the extent the at-risk rules apply to the lessee—the user—or the lessor. By definition, under sections 465 and 46 of the Internal Revenue Code, the at-risk rules essentially do not apply to public corporations, but they do apply to corporations owned by five or fewer shareholders, regardless of whether that corporation is in an active business or whether it is deriving passive income, that is, as a personal holding company.

The effect then, of the temporary regs is that the Senate version language, of the safe harbor provisions, rejected by the full Congress in the statute, is at least conceptually reinstated by Treasury regulation.

Let's look at two practical effects of this. With respect to the investment credit, the leasing statute says that a lessor need have only a 10-percent equity in the basis of the leased asset, to qualify for the full investment credit. The regulations, by superimposing the matrix of the full at-risk provisions, require the lessor to have a 20-percent investment. That's the amount that the 1981 act requires for investment credit at-risk purposes, but only if the lessor is closely held. If not closely held, then the 20-percent requirement does not apply.

With respect to both credit and depreciation deductions, the statute says that as long as the lessor has a 10-percent minimum investment, the other 90 percent can be financed by the lessee in order to get safe harbor lease treatment. The regulations, again by going to a full at-risk concept, say that for every percentage point financed by the lessee—and that's even if the 20-percent at-risk rules for investment credit purposes are met—for every percentage point financed by the lessee, it is required that the lessor scale down proportionately the benefits allowed by the safe harbor provisions. Once more, this is true only if the lessor is closely held, not if it is a widely held corporation.

We are, therefore, concerned about the effect of extending these rules on the competitive position of the closely held business, and that is obviously the way that I am defining small business here.

I can't leave the point, though, without referring back to Mr. Glickman's statement this morning about Assistant Secretary Chapoton's well-known speech at NYU saying that lessors would not be hit with an at-risk rule relating to themselves, but only to the lessee, and then coming up with a conclusion that the leasing regulations cannot add an exception to the at-risk statute without express authority.

I think the very fact that Mr. Chapoton's statement was made just 2 weeks before the regulations came out, makes it clear we are dealing here with a matter that is not a technical issue, but a policy issue. That means, in other words, that the technical result of the decision was not mandated by the statute. It was a policy decision that was made, and that policy decision could have gone the other way as well. Should it have gone this way? I think the

answer is no. And to bolster that point, I would turn to the statement of the managers in the conference committee report on ERTA last year with respect to the leasing provisions.

On page 218 of that report it is stated, and I am quoting here, "The conferees intend that the amount and timing of cost-recovery allowances in the hands of the lessor will be the same as they would have been in the hands of the lessee." That is the end of the quote. Congressional intent seems pretty clear here and doesn't impose a separate at-risk test on the lessor.

These provisions obviously break new ground. The regulations with the at-risk rules have tried to bring them back onto old ground. Given the specific language of the conference committee report, we believe the Treasury was wrong to overturn congressional intent.

A second troublesome area, and one which may not have been discussed in our written statement, but is included in the material submitted to Treasury on the proposed regulations, involves the term of a lease. This is bothersome to small business and also to large business enterprises. The temporary regs provide that the lease term must be equal to a minimum term, defined as the accelerated cost recovery period prescribed by the 1981 act.

Now, a minimum term for safe harbor leasing is not in the statute, and it was not discussed in congressional reports on the bill. Maximum, yes, that is in the statute, but not minimum term; the minimum term is purely a creature of Treasury regulation. Presumably, the purpose is to preclude the lessees, the users, from recovering the cost of qualifying property faster, through rental payments during a shorter base period, than would be possible under the Accelerated Cost Recovery System. The problem is, however, that the provision discourages safe harbor leasing activity where lease terms have historically been shorter than the applicable cost recovery lives, and it is in this area that small business has often been involved. For example, leases in the computer industry, where there is concern about technological obsolescence; leases in the automobile industry—and that need not be General Motors or Ford—but it can be an automobile dealer as well; leasing of property in the construction industry—these are illustrations where the economic useful life of the equipment may be shorter than the cost recovery system.

We have recommended to Treasury that this particular provision of the temporary regulations be dropped, because it does discriminate effectively against smaller businesses.

Taxpayers have experienced difficulty in computing amounts at risk, in addition, because it is not clear whether indemnifications of the lessor's tax benefits by lessees, or third party guarantees, preclude safe harbor leases or reduce amounts otherwise at risk. Under the general at-risk rules, a taxpayer cannot be considered at risk with respect to amounts protected through guarantees, stop-loss agreements, or other similar arrangements, in the words of the statute. However, in a typical safe harbor leasing transaction, lessees are required to indemnify the lessor from the loss of tax benefits. In addition, parties related to lessees, such as a parent corporation, have been required to guarantee the lessee's commitments

under the lease with respect to rental payments and indemnification.

What we are suggesting is that it should be made clear, and this can be done by regulation or ruling in our judgment, that these types of indemnification agreements should not preclude safe harbor lease treatment. We believe that there are private rulings apparently available on economic protection for widely held corporations. We would like to see the IRS publish rulings, or Treasury publish regulations, or Congress provide legislation, if the other two are not forthcoming, which would provide equal protection to the closely held company.

The final point, not a technical one, is one of the problems that any business, small or large, has, given the complexity of the tax laws, and the use of tax laws as incentives or disincentives for various types of business activity. We are referring to stability of legislation. We have certainly seen, in the case of investment credit, the problems that lack of stability can cause; and I don't want to take you through a year-by-year history of the investment tax credit. But with respect to the whole concept of putting in safe harbor leasing yesterday, taking it out today, restricting it today. There were comments made earlier this morning about whether or not business or segments of business are productive or efficient. Clearly, the instability of legislation which so affects business is not something that is going to lead to increased efficiency or productivity. We are suggesting that businesses ability to plan, even in the intermediate term, and certainly short term—say more than 1 year, but less than 3—is severely hampered by the constant flip-flop of legislative initiatives. What we would like very much to see is small business given the same opportunities to compete with respect to safe harbor leases as are large businesses, and that is the thrust of our testimony.

We would like very much also, however, to ask you to consider as one of the policy matters you have to deal with the ability of business at all to make plans intelligently where legislation constantly keeps shifting.

Mr. Glickman pointed out this morning the fact that the safe harbor lease provisions applicable to small businesses really are only timing differences. The at-risk rules only dictate the time for claiming deduction or credit, not whether a company is going to be entitled to investment credit or depreciation deductions. Let me close by saying he is right but, unfortunately, that is not the whole story.

Clearly, to the extent that the smaller lessor cannot compete to provide safe harbor lease tax benefits because of the at-risk rules, even though only timing is involved, the cost to the lessee of obtaining safe harbor leases from those lessors has to be higher. The effect is still to put the smaller, closely held company at a competitive disadvantage, and that is what the American Institute of CPA's would like to see you change.

Thank you.

[Mr. Padwe's prepared statement follows:]

PREPARED STATEMENT OF GERALD W. PADWE, CPA, FEDERAL TAX DIVISION,
AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

COMMENTS ON AT RISK RULES AND THE SMALL BUSINESS FIRM

SUMMARY OF COMMENTS

1. The temporary regulations published October 20, 1981 for tax benefit or safe harbor leases appear to go beyond congressional intent in imposing the at risk rule on the lessor, and should be expanded to clarify the availability of letter of credit and guarantee protections for a lessor notwithstanding the general stop-loss rules of §465.

2. The investment tax credit at risk rules added by §46(c)(8) discriminate against non-recourse automotive vehicle and equipment financing by manufacturers and dealers. Temporary regulations are needed to clarify application of the stop-loss rules and at risk procedures for qualified independent lender financing.

3. Extension of the §465 at risk rules in the 1978 Revenue Act to active trade or business, and investment activities, and to closely-held regular corporation entities has created conceptual difficulties which may be resolved only by confining application of these rules to discrete abusive tax shelter activities undertaken by partnerships or corporations engaged in an active trade or business or investment activities. Regulatory interpretations are badly needed.

4. The 1980 Technical Corrections amendments to §465, which permit equipment leasing corporation activities, discriminate against small business firms, without serving the congressional purpose of curbing abusive tax shelters.

5. The regulations proposed in 1979 for the §465 at risk rules are unsatisfactory even for the 1976 Revenue Act - prescribed tax shelter activities, and must be expanded to cover the extension of the §465 at risk rules to active trade or business and investment activities, and to regular corporation taxpayers.

TAX BENEFIT LEASES - TEMPORARY REGULATIONS

At Risk Rule

The principal problem posed for the small business firm in the tax benefit lease involves the at risk rule both for tax losses (depreciation and interest) and investment credit. The temporary regulations published October 20, 1981 compounded the difficulty by extending these at risk limitations to the lessor, in §5c168.(f)(8)-7(f).

This imposition of the at risk limitation at both lessee and lessor levels arguably is supported by §168(f)(8)(G) which authorizes regulations to limit the aggregate amount of and timing of deductions and credits to those which would be allowable in the absence of the tax benefit or "safe harbor" provisions. However pages 106 and 107 of the General Explanation of the 1981 Economic Recovery Tax Act, prepared by the staff of the Joint Committee on Taxation ("1981 ERTA General Explanation") refer only to the timing of recovery (depreciation) deductions and income deferral to the lessor.

A comparison of the tax benefit lease lessor eligibility rules appearing in H.J. Res. 266, which would have made a closely-held corporation ineligible as a tax benefit lessor, and H.R. 4242 (the version finally enacted) which precluded only a personal holding company from serving as a lessor indicates a congressional intent to permit a closely-held regular corporation to "purchase" tax benefits under the safe harbor lease provision.

This interpretation was confirmed in an address of Mr. John A. Chapoton, Assistant Secretary of the Treasury for Tax Policy in an address to The Tax Society of New York University on October 5, 1981 in which Mr. Chapoton stated:

> "a purchaser of tax benefits under a safe harbor lease will not be limited by the at risk rules from claiming the credits and deductions that would have been available to the lessee".

Indeed §168(f)(8)(B)(ii)(II), 168(f)(8)(C), and 168(f)(8)(E) literally indicate that the only at risk requirement for the lessor should be its 10% minimum investment.

The temporary regulation at risk limitation refers both to the investment tax credit provisions and §465 applicable to the lessee or the lessor. In some cases the lessor can satisfy the investment credit at risk rule, appearing in §46(c)(8) and discussed in the next section of these comments, then can satisfy the §465 loss deduction at risk limitation provisions through use of a leasing corporation, which satisfies §465(c)(4)-(6). However where the leasing subsidiary is owned by a closely-held parent corporation regulation 1.1502-45(a) confines use of the depreciation deductions and investment credits earned by the subsidiary in the consolidated return only to the extent that the parent corporation is at risk with respect to its investment in the subsidiary.

Even if the leasing corporation is organized as a sister, rather than a subsidiary, corporation so that the consolidated return regulation limitation does not apply, the subsidiary must meet strict tests including operation for at least the current and two prior taxable years, at least three employees engaged full-time in leasing activities, formation of at least five lease transactions and at least $1,000,000 in gross receipts from leasing during the taxable year. None of these requirements applies if the leasing corporation or the parent corporation is widely held.

Stop-Loss Provisions

The second area of difficulty for the small business firm arises from the lack of guidance in the temporary regulations as to application of the "stop loss" provisions in §465(b)(4). It is understood that the Internal Revenue Service has issued Private Letter Rulings, albeit usually in the widely-held corporation context, that a tax benefit lessor can exact economic protections including a bank letter of credit to secure the lessee's rental obligation as well as the lessee's indemnification to the lessor for lessee actions which would disqualify the lesse for §168(f)(8) e.g. sublease, assignment to a non-consenting substitute lessee and transfer of use outside the United States.

In addition favorable PLR's have been issued where the lessee's rent obligation and tax indemnifications have been guaranteed by the lessor's parent corporation. It is believed that such guarantees are supported by the precedent of §4(5) of Rev. Proc. 75-21, relating to "true lease" Private Rulings and by Secretary Chapoton's address, mentioned above.

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If the tax benefit lessor can protect itself by a bank letter of credit security, and parent corporation guarantees, the lease transaction can be combined with a procedure under which the lessor undertakes full at risk exposure. This could take the form of a bank loan obtained by the lessor sufficient to purchase the equipment from the lessee, and on a principal and interest repayment schedule which synchronizes with the rentals to be paid by the lessee.

If these assumptions are accurate, the Internal Revenue Service should issue published guidance to explain the availability of the procedure, and the economic protections, in order to facilitate lessor participation by closely-held corporations in the tax benefit area. Such guidance should include the permissibility of "lessor" or "residual value" insurance coverage purchased by the lessor, with the related premiums borne either by the lessor or the lessee.

Shortcomings of Regulations

The third area of concern relates to omissions from the temporary regulations, or unnecessary restrictions. Areas which should be considered include the following:

1. Satisfaction of the lessee and lessor at risk rules, as of the inception of the lease, should be sufficient.

2. The loss realized when the lessee sells for a price smaller than the adjusted basis of the equipment should be recognized.

3. A sublease of the equipment should be permitted where the sublessee consents to the tax benefit lease rules, the same as a substitute or assignee lessee, under Reg. 5c168.(f)(8)-2(a)(5).

4. Rules should be provided for sale of investment tax credit benefits in the additional credit percentage available when the lessee is contributing to a TRASOP.

5. Rules should be provided for safe harbor leasing by manufacturers and equipment dealers.

State Tax Burdens

A final area of concern relates to state tax reporting problems, including refusal by certain states to accept a tax benefit lease, unless it also qualifies as a lease under the former "true lease" IRS guidelines, and the imposition of a state sales or use tax on the equipment sale and lease-back. Congress might consider enactment of a pre-emption statute in order to achieve its initial objectives of facilitating the transfer of tax benefits.

INVESTMENT CREDIT AT RISK RULE

Qualified Non-Recourse Lender

No regulations have been proposed or published on the investment tax credit at risk rules added by §46(c)(8) and (9) for equipment placed in service after February 18, 1981. Although no explicit regulatory authority is provided in this enactment, §46(c)(8)(B)(i) refers to §465(b) for the at risk definition. This should make pertinent the Internal Revenue Service explicit regulatory authority in §465(c)(3)(C) and (E) related to at risk definitions for a taxpayer engaged in trade or business or investment operations, other than the originally prescribed "tax shelter" activities listed in the original 1976 version of §465. This cross-reference should also accommodate regulatory interpretations to exempt equipment purchases not involving tax shelter characteristics.

The 1981 General Explanation indicates that the qualified (non-recourse) financing rule of §46(c)(8)(B)(ii) is available where a qualified lender holds 9% of the equipment purchaser's stock i.e. less than 10%, but precludes financing in the form of a convertible debt, even though such conversion could only be into a stock ownership smaller than 10%. In addition the General Explanation precludes qualified financing in the form of a general business purpose loan, and requires specific equipment financing. If the taxpayer can obtain non-recourse financing from qualified a person as defined in §46(c)(8)(D), and if the purchase does not have tax shelter characteristics both convertible debt and general purpose business loan financing should be permitted.

The tax shelter characteristics are described in the 1978 Revenue Act General Explanation at page 133 as including property value subject to substantial uncertainty, activities of a speculative nature, and unavailability of similar financing on similar terms from unrelated, commercial lenders. These characteristics are inconsistent with the financing which would be obtained from a qualified person. The equipment is being purchased in an active market where values can be readily ascertained, for use in an operating trade or business and in a transaction certainly not constituting a tax abuse sought to be prevented by congress with the at risk provisions.

§46(c)(8)(D)(iv) disqualifies an equipment seller or related party as a qualified lender. Historically small business, and other firms, have acquired motor vehicles and other equipment on non-recourse financing from the equipment

manufacturer, dealer, or a related finance company. Congress should consider an amendment to clause (iv) to permit the continuation of this type financing, and immediate investment credit availability to the purchasing taxpayer, or where applicable, its tax benefit lessor.

Business or Investment Real Estate

Another area in which clarification should be obtained by amendment of the statute, if necessary, or otherwise by regulatory interpretation involves the §1245 components of real property (building), when such components qualify as §1245 and §38 (investment credit) property. It is understood that although "componentizing" no longer is permitted for the ACRS recovery (depreciation) deduction allocation of the building costs to the §38/1245 components is still required. The cost of such components should be eligible for the investment credit and the tax benefit provisions.

The uncertainty relates to applicability of the at risk rules. §465(c)(3)(D) excludes real property used in a trade or business, or for investment purposes, other than the five 1976 prescribed at risk activities, from the at risk provisions. However §465(c)(1)(C) designates leasing of §1245 property as an original 1976-prescribed at risk activity.

Many small business firms arrange their operations with the real estate owned by an individual shareholder or shareholders, or sometimes a sister corporation, for lease to the operating corporation. Such rental activity qualifies at least as an investment activity, or under the Leland Hazard case as a trade or business activity. The §465 regulations proposed June 5, 1979 do not consider this point, presumably because they relate only to the pre-1978 Revenue Act specified activity at risk rule.

Regulations should be provided to clarify eligibility of the §1245 components in such real estate leased to a small business firm as eligible for the investment credit, and tax benefit leasing. The suggested regulation regarding investment credit eligibility is consistent with the ERTA amendment which permits a non-corporation lessor to claim investment credit on leased qualified rehabilitated building property.

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As discussed in more detail below in the next section, the regulations should clarify the stop-loss rules for both leased and unleased property.

AT RISK RULES - 1978 ACT AND 1980 TECHNICAL CORRECTIONS

Regular Corporation Activities

Most of the at risk problems which affect small business derive from the 1978 Revenue Act extension of the at risk limitations to a closely-held regular corporation and the at risk suspended loss rules to all activities, beyond the original 1976-prescribed "tax shelters", except for real property activities. No regulations have been proposed or published on these enlargements of the at risk rules. The absence of such regulations may reflect conceptual difficulties in defining a suspended loss activity where an active trade or business is being conducted by a regular corporation.

The original at risk concept was designed to curb abusive tax shelters which produced unwarranted tax benefits on individual returns of a proprietor, partner, or Subchapter S shareholder in an activity which was clearly defined and revolved around non-recourse financing. This concept was confirmed by §465(c)(3)(B), relating to the extension of the at risk rules to non-tax shelter activities and providing for aggregation of activities where an active trade or business is conducted. This sub-paragraph (B) permits aggregation of trade or business activities only in the proprietorship, partnership, or Subchapter S corporation context.

The 1978 Act General Explanation at page 130 indicates the purpose of extending the at risk limitation to a regular corporation was to prevent "use of tax shelter deductions to avoid the accumulated earnings tax". Pages 131-132 of the explanation refer to tax characteristics such as accelerated deductions, mismatching of income and deductions, substantial non-recourse financing, non-standard commercial practice financing techniques, property whose value is subject to substantial uncertainty, and marketing of the activity to prospective investors as a tax shelter. It would appear that the intent of Congress was to apply the 1978 Revenue Act extensions only where a closely-held corporation invested in a discrete abusive tax shelter type activity.

Regulations are badly needed to articulate this intent. This would remove a source of substantial concern to the small business firm, particularly the closely-held regular corporation, and avoids the conceptual problem of identifying a suspended loss, and after February 19, 1981 a suspended investment credit, incurred as an integral part of an active trade or business conducted by the firm. Regulations are also

needed to clarify the "automatic non-recourse" rule of §465(c)(3)(E), which permits loans from related taxpayers, i.e. shareholders of the firm, for trade or business activities not involving the 1976-prescribed tax shelter activities.

Real Estate

Clarification is also needed, as mentioned in the section above, regarding the status of §1245 components of a building and applicability of non-recourse financing for such components, under the exclusion from the at risk rules for real property, appearing in §465(c)(3)(D).

In regard to real estate Congress may wish to address the difficulty faced by a decedent's estate, which owns real property, either directly held by the decedent, or held by a sister corporation owned by the decedent, and leased to an operating corporation owned by the decedent. The Internal Revenue Service in recent Technical Advice Memorandums 81-34-012 and 81-40-020 has advised the pertinent IRS field office that the estate tax installment payment plan provisions of §6166 are not available to a holding company or to a sister corporation real estate lessor. Similar adverse advice has been issued where the real estate had been retained by the individual proprietor when he incorporated his business.

A well-advised small business firm owner could have obtained the §6166 payment plan by transfer of the real estate into the operating corporation, or merging the real estate corporation into the operating corporation, prior to his death. Congress may wish to clarify availability of §6166 in these circumstances, particularly since this type controversy is handled by the Internal Revenue Service as a "collection" rather than "audit" activity, which makes judicial recourse on this issue by the estate unavailable.

Equipment Leasing Corporation

Also as mentioned in the section above strict tests are required by §465(c)(4)-(6) where there is a closely-held leasing company or subsidiary of a closely-held parent corporation.

Congress might wish to relax these restrictions and permit any regular corporation to serve as an equipment lessor, without limitation under the at risk rules, in order to further capital formation.

Mention should be made that the present rules, which can result in a suspended loss, and now suspended investment credit, where the restrictions are not satisfied in every particular, makes the leasing corporation an attractive "tax shelter" buy-out by a widely held corporation, i.e. the purchaser can utilize the deferred losses and credits immediately after acquisition of the leasing corporation.

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Finally in regard to the 1978 extension of the at risk rules to closely-held corporation there should be clarification as to whether the disqualifying five or fewer stockholders extends to an employee stock ownership plan. The 1978 General Explanation at page 134 indicates that a "pension trust" is such a stockholder.

AT RISK RULES - 1976 ACT REGULATIONS

Very brief temporary regulations were adopted August 19, 1977 under the §465 1976-prescribed tax shelter activities and elaborate regulations were proposed June 5, 1979. The latter were strenuously contested at hearings conducted by the Internal Revenue Service, and no further rule-making has occurred. Apparently only six published rulings have been issued by the Internal Revenue Service for guidance of taxpayers. Shortcomings of the proposed regulations, as perceived by taxpayers and their representatives have been accentuated by the extension of the §465 at risk rules to ordinary trade and business, and investment, activities, as well as to the closely-held regular corporation entity. Areas of concern include the following:

1. Insufficient guidance is provided in proposed Regulation subsections 1.465-13 and -38 for the interplay of the suspended at risk loss deduction with the carryovers for unused charitable contributions, net operating losses, deferred excess investment interest expense, and capital losses, as well as the interplay between the suspended investment tax credit and carryovers for unused investment credit and foreign tax credit. In addition it appears that a regulatory concept similar to the tax benefit rule of §58(h) related to tax preference items should be included.

2. Guidance is needed as to the definition of activity, particularly the aggregation of activities for an active trade or business, and transfers of funds, and/or incurrence of debt among these activities.

3. Proposed regulations are structured, e.g. at subsections -7(a) and -8(b), to press partners or stockholders to contribute capital rather than guaranteeing loans made to the business entity. This pressure leads to incurrence of debt outside the partnership or corporation by the principals, and subject to the excess investment expense disallowance rules in §163(d). No regulations have been issued under this provision, and no action has been taken on the proposed regulations in §1.57-2, related to the now repealed treatment of excess investment interest expense as a tax preference item.

4. The proposed regulations in subsection -6(a) should be expanded to interpret the stop-loss provision of §465(b)(4). These regulations should be expanded, to remove from the stop-loss concept, protections which a taxpayer can negotiate in a transaction such as lease obligations and

covenants, a stock or partner interest buy-sell agreement, and insurance coverage beyond the casualty insurance referred to in the 1978 General Explanation at page 129. The stop-loss provision should be confined to promoter guarantees in transactions having abusive tax shelter characteristics.

5. Proposed regulations subsection -8 should be clarified; the existing language appears to preclude venture capital financing by a small business firm in the form of convertible debt or where the lender takes back a stock purchase warrant.

6. The "back-to-back" loan provision for Subchapter S shareholders in subsection -10(b)(2) should be expanded to include such loans made to a regular corporation by its shareholders.

7. Proposed subsection -22 should be revised to accept a limited partner subscription, or partner, Subchapter S or regular corporation shareholder note to an active trade or business entity as creating at risk for the subscriber or note maker.

8. A regulation should be added to clarify the §691(b) deduction in respect of a decedent status for a proprietor, partner or Subchapter S shareholder who has suspended at risk losses.

9. Another provision should be added to clarify the treatment of §465 suspended losses and §46(c)(8) suspended investment credits, upon the incorporation of a partnership or proprietor ship.

Mr. NOWAK. Thank you very much. We appreciate your very detailed testimony, and your very good substantive arguments. A regulation change, which can be argued—as you have very effectively—I think is already in the law and in the conference report. So thank you very much for coming. As accountants—people who will be working with this—we wanted to have your testimony, and at the same time, we wanted to give attorneys, the other half of the profession here that will be participating, an opportunity. We have now an attorney who has been working in this area and his partner with him from Buffalo, N.Y.: Leonard Kriss is a partner of Diebold, Millonzi, Raiser, and Robshaw, and they have law offices here in Washington as well as in Buffalo, N.Y. We want to welcome you and give you the opportunity for equal time on behalf of the attorneys.

TESTIMONY OF LEONARD G. KRISS, PARTNER, DIEBOLD, MILLONZI, RAISER, & ROBSHAW

Mr. KRISS. Thank you very much, Mr. Chairman. I will keep my remarks very brief and would only like to highlight several of the areas that have not previously been addressed by the other speakers.

One thing that I believe must be kept in mind in the midst of the current clamor for repeal of the safe harbor leasing provisions: and that is the underlying basis for this clamor. Obviously, the projected budget deficits, together with the experience with the safe harbor leasing provisions to date, result in the perception that only big businesses have taken advantage of these provisions. While it is obviously very difficult to refute this argument, the fact of the matter is that experience to date is not an accurate indicator of the potential benefits of the safe harbor leasing provisions to small business.

Unfortunately, the biggest aberration in the leasing legislation was something which had no relationship to the alleged purpose of the leasing provisions, the stimulation of economic growth and capital investment. The retroactive provisions, by definition, could not accomplish these goals and were a general invitation to the sophisticated and by nature the large corporation to participate in the wild scramble to simply pickup as much in the way of tax benefits for capital expenditures that had previously been made by the transferors of those benefits.

Obviously, based on the experience with the retroactive provisions, one can only conclude that big business was the primary beneficiary. Unfortunately, by the nature of the game, small business, had no interest in the retroactive provisions since they are nowhere nearly as sophisticated, nor do they generally retain advisers who are as sophisticated as, for example, the Wall Street law firms who had round the clock staffs ready, willing, and able to document these large transactions while waiting for the eleventh hour for the temporary regulations to be issued by the Treasury Department.

As a result of the practical constraints on small business and the fact that small business operates within certain traditional financing concepts leasing was not attractive and may not be attractive

for, perhaps, several months to come. I believe that there is a certain period of education and indoctrination which must occur for small business to not only become more familiar with the leasing provisions and how they work and their advantages, but also to move away from the traditional methods of financing capital improvements.

While it is clear that the results to date have not been ideal from the perspective of the small businessman, repeal of the safe harbor leasing provisions at this point, without the benefit of seeing the true impact on small business, in my opinion, would be compounding the problem. We cannot recover the investment tax credits and ACRS deductions of the IBM's and the other major corporations which were obtained under the retroactive provisions. The problem, however, would be compounded if we repeal these provisions in their entirety without giving small business any realistic opportunity to take advantage of them. Several suggestions which we have presented in our testimony have already been addressed. There are two in particular which have not and which I would like to mention briefly.

One of the primary concerns in a safe harbor leasing transaction relates to the potential for recapture by the lessor in the event of an involuntary transfer of the leased property. This would, of course, result from a foreclosure sale by a creditor or the sale by a trustee and bankruptcy in the event of insolvency. Obviously, in the context of small business, this becomes an extraordinary consideration from the lessor's standpoint since the financial resources are not as great as they would be in the case of a large corporation.

The Treasury Department, in its proposed regulations, took the position that recapture would occur under all circumstances in the event of an involuntary transfer of the leased property. The department relented on that point in the temporary regulations which were issued in November and provided a mechanism whereby a lessor could avoid the recapture consequences if he observed certain filing and notice requirements and obtained the consent of the secured creditor. While in theory this sounds like a fairly simplistic mechanism to protect the lessor, in practice it seems to me virtually impossible that a secured creditor would consent to the continuance of tax benefits on the part of the lessor when he has in his possession a piece of property which he must sell in an attempt to recoup at least part of his loss. How can one hope to sell property without the tax benefits associated with that property going to the prospective transferee in an already distressed context. In my opinion, this would at the very least, diminish the value of the property from the perspective of a potential transferee.

As a practical matter, I believe that amendments must be made to reduce the chance of recapture by a lessor in a safe harbor leasing transaction and to allow a transferee in an involuntary transfer situation to retain the tax benefits also. Now, this obviously appears to conflict with all tax policy and philosophy that has ever been promulgated, but perhaps it is not as outrageous as it appears at first blush. The fact of the matter is that, when the property is transferred in a distress sale, it is used property for purposes of the investment tax credit. It is sold under distress conditions, circumstances which obviously reduces the value of that property and con-

sequently the basis for computing an ACRS deduction. Assuming that the legislation was intended to stimulate capital investment, it is on balance a relatively small price to pay to encourage small business to take advantage of the leasing provisons.

An amendment of this nature would obviously contribute to the continuing loss of revenues by virtue of the duplication of tax deductions and credits by both the lessor in the original leasing transaction and the transferee upon the subsequent sale. However, this amendment, together with the imposition of a limitation on the aggregate amount per year of ACRS and investment tax credit which could be taken in a safe harbor leasing transaction would limit the utilization of this provision by the large corporation. While it would, to an extent, be discriminatory, it would not knock them out of the box entirely.

In addition, closing existing loopholes as evidenced by the *Occidental Petroleum* case, which allows a corporation which has virtually no tax liability because most its income is generated abroad, and gives that corporation the further opportunity to pass on ACRS deductions and investment tax credits to another conglomerate, would more than offset any amendment of the type which I have suggested to protect the lessor. This is especially true in the small business context, where the creditworthiness of the lessee in the transaction more times than not could be the determinative factor and perhaps could preclude the transaction from ever taking place.

The second point which I believe will provide further accessibility to the safe harbor leasing provisions and which has not been addressed is the so-called investment tax credit strip-out transaction which allows only the transfer of the investment tax credit to a lessor in a safe harbor leasing transaction and the retention by the lessee of the ACRS deduction. Prior to the enactment of the Economic Recovery Tax Act, these transactions, while not specifically being sanctioned, were consummated on a fairly regular basis. The Treasury Department has reserved its decision as to whether the investment tax credit strip-out transaction will be authorized under the safe harbor leasing provisions.

It would appear to me that this type of transaction provides an incentive for the small corporation which is interested in financing a capital improvement while at the same time looking toward the day when that company will become profitable. The lessee can retain the depreciation or ACRS deduction in order to improve its position in the event that it does become profitable.

The ITC strip-out transaction would, No. 1, allow the lessee or the seller of the investment tax credit to receive cash well in advance of the time he could take advantage of the investment tax credit and would further provide an improved source of cashflow. This type of transaction would have particular appeal to small business.

Finally, I believe that the 3-month placed-in-service limitation for small business is perhaps a bit too harsh. When we look at small business, we must consider an entity that is first coming into existence, and does not know where it is going and does not know how funds will be generated in order to make capital improvements. I think this would be a fairly innocuous amendment to the

existing regulations and might provide further accessibility to the provisions of the safe harbor leasing provisions for small business.

In conclusion, I would just like to state that I believe one must view the safe harbor leasing provisions in the context in which they have been utilized in order to assess the viability of the safe harbor leasing provisions from the small business standpoint. I would submit that repeal prior to the time when we can get an accurate indication of its viability as a financing vehicle for small business, absent some other assistance, would be a dramatic mistake.

Thank you.

[Mr. Kriss' prepared statement follows:]

PREPARED STATEMENT OF LEONARD G. KRISS, PARTNER, DIEBOLD, MILLONZI, RAISER & ROBSHAW

INTRODUCTION

The Economic Recovery Tax Act of 1981 ("ERTA") introduced an entirely new capital cost recovery system ("ACRS") and substantially revised the investment tax credit. Under ACRS, most depreciable property is assigned one of several recovery periods which periods are generally shorter than the useful lives applicable under the prior Asset Depreciation Range system. As a consequence, cost recovery deductions are available earlier, when they may be more valuable. The rules relating to the investment tax credit were revamped in order to allow a more generous credit. Under ERTA, a full ten percent credit is available for five, ten and fifteen year property and a six percent credit is available with respect to three-year property.

It was correctly perceived that these tax advantages were of little use to businesses without sufficient tax liability to absorb them. Almost fifty percent of American corporations pay no federal income tax and it had been estimated that by the mid-1980's, over $10 billion in unused credits would accumulate annually. To a company with a history of net operating losses or unused investment tax credits, the prospect of accelerated depreciation deductions and generous investment tax credits is little cause for celebration. A backlog of unused deductions and credits not only stymies incentive for capital investment, it also creates a competitive disadvantage since the cost of capital equipment remains the same regardless of the financial condition of the investor.

The present administration's response to this dilemma was to press for the enactment of §168(f)(8), which completely revised existing rules and regulations relating to leasing transactions. The now "safe-harbor rules" facilitate utilization of ACRS deductions and investment tax credits by corporations with sufficient tax liability to benefit from them. On a larger scale, they serve to stimulate capital investment and economic growth.

Large corporations have to date been the principal beneficiaries of the safe-harbor leasing provisions. Ford Motor Co., for example, reportedly sold approximately $1 billion in unused credits and deductions to IBM for a price estimated between $100–$200 million through use of safe-harbor leases. While an overwhelming number of leasing transactions are not made public, it does appear that small business has not yet moved to take advantage of the tax benefits available under §168(f)(8). Moreover, it has been conservatively estimated that as a consequence of the new safe-harbor vehicle, over $29 billion in revenue will be lost to the Treasury over the next six years.

Nevertheless, repeal of these provisions would be a monumental error. With certain adjustments, the leasing provisions will prove to be of benefit to small business. I intend to explain why small business has not yet taken advantage of the safe-harbor and will also offer several proposals, which if adopted, will facilitate small business capital investment through use of the safe-harbor.

THE PRESENT UTILIZATION OF § 168 (F) (8) BY SMALL BUSINESS

The safe-harbor provisions were intended to encourage small business capital investment by lowering the cost of such investment. This result is accomplished through use of a "sale-leaseback" arrangement. For example, assume that Little Corp., paying no federal income tax because of operating losses, wishes to purchase a widget costing $100,000 and Big Corp., a profitable firm presently taxed at the

highest corporate rates, would like to purchase the tax advantages of owning the widget. After Little Corp. purchases the widget from a vendor for $18,000 in cash and an $82,000 note, Little Corp. and Big Corp. enter into an agreement qualifying for safe-harbor treatment under §168(f)(8). Pursuant thereto, Big Corp. purchases the widget from Little Corp. for $18,000 in cash and assumption of the $82,000 note. Little Corp. also agrees to lease back the widget from Big Corp., paying in rent the amount required to fund the debt service on the $82,000 note. At the end of the lease, the widget belongs to Little Corp. The lease transaction enables Little Corp. to purchase a $100,000 widget for $82,000, and, in effect, to sell the tax benefits for the amount of its prior down payment. Big Corp. gains substantial tax advantage through use of ACRS deductions and investment tax credits which passed to it upon purchase of the widget.

Legislation designed to repeal or substantially modify §168(f)(8) has been proposed in part because it is perceived that the statute is of advantage only to large corporations, rather than the small corporations for which it was primarily intended. While these large corporations have thus far proven the principal beneficiaries of § 168(f)(8), this is primarily due to the fact that safe-harbor leasing was at the outset a relatively new adventure for corporations, investment bankers, attorneys and accountants.

As a consequence, expenses connected with most initial safe-harbor leasing transactions were artificially high. Since leases, indemnification agreements and other necessary documents had to be drafted from scratch, legal fees incurred in connection with a $250,000 transaction were thought to be similar to those incurred in connection with a multi-million dollar transaction. Furthermore, only corporations contemplating large sales of tax credits and deductions had sufficient access to investment banking firms positioned to broker the new leasing transactions. These factors served to discourage small business from taking advantage of §168(f)(8) immediately after its enactment.

The perception that only large corporations will benefit from the enactment of §168(f)(8) was reinforced by the well-publicized efforts of certain large corporations to take advantage of provisions permitting retroactive leasing of property placed in service after December 31, 1980, but before the enactment of §168(f)(8). Only corporations having ready access to a battery of attorneys, accountants and investment bankers were poised to meet the November 13, 1981 deadline for entering into retroactive leases with respect to such property, particularly since the temporary regulations were revised just prior to the deadline. As a practical matter, investment bankers and leasing companies were understandably more eager to arrange a few large transactions prior to the deadline, rather than many smaller ones. While these facts of life lent credence to the belief that the §168(f)(8) safe-harbor was intended to be enjoyed only by large corporations, the wild scramble to take advantage of the retroactive provisions should be viewed as having no effect upon prospective usage of §168(f)(8) by small business.

Moveover, there existed initially much confusion relative to the structure of leasing transactions sanctioned under §168(f)(8). The statute itself provided only the barest framework and the first temporary regulations were not issued until October 20, 1981. The Financial Accounting Standards Board did not provide accounting instructions until October 29, 1981 and the Internal Revenue Service released a major clarification of the temporary regulations shortly before the November 13, 1981 deadline for entering into retroactive transactions. With so much uncertainty, it is not surprising that only the largest and most aggressive corporations dared enter into retroactive §168(f)(8) leases.

To date, there has been a failure on the part of many small corporations and their attorneys to fully comprehend the potential of §168(f)(8). If given the opportunity, safe-harbor leasing will become a viable alternative to traditional methods of financing capital investment. It will take, however, a period of time before small businesses and their legal representatives are prepared to consider it as such. Many small businesses need such times to be made to feel confident in the safe-harbor as an additional or alternative means of financing capital investment.

The fact that small business has not yet taken advantage of section 168(f)(8) is also a function of the economy as a whole. Skyrocketing interest rates have discouraged capital investment and while inflation has in recent months subsided, it too has had a residual effect on economic growth. Small businesses are affected by these nationwide trends, perhaps even more so than large corporations. As the economy improves, so will the willingness of small business to make capital investments through vehicles such as safe-harbor leases.

For these reasons, our initial experience with section 168(f)(8) equipment leasing is in all likelihood not an accurate indicator of events to come. As time passes, most

leasing companies and legal, accounting, and investment banking firms will become sufficiently experienced or efficient so as to make feasible in the near future leasing transactions involving small businesses. Transactions in the $500,000 range, and eventually, transactions involving as little as $200,000, should in the future become commonplace.

In view of the relative newness of the safe-harbor, (final regulations have still not been issued) it would be a mistake to repeal or substantially modify section 168(f)(8) on account of the perception that only large corporations may obtain advantage from it. Even if this were true, it is simply too early to tell. An informed assessment of safe-harbor leasing as a means of encouraging small business capital investment cannot be made until a longer period of time has elapsed.

I believe that Congress made a major mistake in adopting section 168(f)(8) in its present form. The Congress was unduly swayed by several large, troubled corporations who pushed for the adoption of the retroactive leasing provisions. These provisions should never have been adopted.

But it would be a mistake of equal magnitude to now repeal section 168(f)(8) in its entirety. This section was intended to benefit small business and encourage capital improvement and investment. It would be counter-productive to quit now.

The effect of the prior mistake, that is, the retroactive leasing provisions, has been fully felt and is over. The deadline has passed. Future efforts can and will be directed toward the achievement of the initial goal.

PROPOSALS

As a practical matter, small businesses have thus far not taken any meaningful advantage of safe-harbor leasing under section 168(f)(8). However, I am convinced that small businesses will in the future become active participants in safe-harbor leasing transactions and it is possible to facilitate this development through the implementation of some of all the measures suggested below. The following proposals are offered in the hope of enhancing the ability of small businesses to utilize the safe-harbor, thus stimulating capital investment.

1. Retention of tax benefits by lessor

Small business participation in safe-harbor leasing transactions has been significantly hindered by the Internal Revenue Service's ("IRS") present position with respect to dispositions made by the lessee. Initially, the IRS indicated that upon the occurrence of certain of such dispositions, the lessor's credits and deductions would be subject to recapture. However, by the time it issued temporary regulations under section 168(f)(8), the IRS had softened its stance considerably.

Under the temporary regulations, if a lessee voluntarily sells or assigns its interest in a safe-harbor lease the voluntary sale on assignment constitutes a disqualifying event causing the lease to cease being characterized as a safe-harbor lease unless (1) within 60 days, the transferee furnishes to the lessor its consent to take the property subject to the lease, and (2) the transferee and transferor file special information statements with their respective tax returns. Where a lessee's interest is sold or assigned in bankruptcy or other similar involuntary proceeding, a safe-harbor lease will continue to be characterized as such if (1) certain notices are given by the lessor to the judicial or administrative body having jurisdiction, the party in possession and the purchaser or assignee (2) the lessor files an information statement with its tax return and (3) prior to the sale or assignment, all secured lenders of the lessee with interests in the subject property exclude or release the federal income tax ownership of the property. In either case, however, the lessor is subject to the recapture rules under Internal Revenue Code sections 47 and 1245 unless all of the applicable conditions are satisfied. This is particularly important to the lessor where insolvency or bankruptcy of the lessee is a realistic concern, since there are several circumstances under which not all secured lenders of the lessee will release federal tax ownership of the subject property.

The threat of recapture continues to discourage lessors from entering into safe-harbor leases with high credit risk lessees, many of whom are small businesses. Often, a lessor's only protection against the possibility of recapture is to require the lessee to sign an indemnification agreement and furnish security therefor, often in the form of a letter of credit. Such letters of credit, if available, usually require payment of an annual percentage fee by the lessee. From the standpoint of small business, these additional arrangements are both expensive and burdensome. Depending upon the lessee, the additional burdens may render an otherwise feasible transaction unworkable. At the very least, the value of credits and deductions sold by the lessee is diminished.

The regulations should be amended to permit ACRS deductions and investment tax credits to be retained by the lessor regardless of any voluntary or involuntary transfer made by the lessee. As a matter of logic, this makes sense. Under § 168(f)(8), the lessor is the owner of the leased property for federal tax purposes. Since the lessor has transferred nothing, there should be no tax effect to him upon a disposition by the lessee. As an equitable matter and a matter of policy, it seems unduly harsh to deprive a lessor of the benefit of his bargain as a consequence of managerial and operational failures of the lessee, over which the lessor has no control.

Theoretically, retention by the lessor of his bargained for tax benefits would work to the detriment of secured creditors having interests in property subject to a § 168(f)(8) lease. If upon repossession, such a creditor wished to sell the property, the value of the property would be decreased significantly by virtue of the fact that the attendant tax benefits were to be retained by the lessor. In order to overcome this difficulty, it would be necessary to permit the purchaser of the used equipment to simultaneously take ACRS deductions and claim investment tax credits with respect to the property concurrently with the lessor until the term of the lease expires. While income tax theoreticians will likely rebel against such a proposal, it is arguably a small price to pay for stimulation of small business capital investment.

By amending the regulations in this way, potential lessors would be far more inclined to enter into safe-harbor leases with less credit-worthy companies, many of whom are small businesses. Since the danger of recapture would be reduced significantly, the importance of indemnification agreements in connection with leasing transactions should theoretically decrease. This should be attractive to small businesses who are arguably deterred from entering into leasing transactions by the cost and continuing exposure associated with such agreements.

2. Investment tax credit strip

The text of § 168(f)(8) and its legislative history imply that safe-harbor leases will usually involve either of two types of transactions. The first, known commonly as a "sale-leaseback," permits both ACRS deductions and investment tax credits to be transferred through a safe-harbor lease. As indicated in my earlier example, a sale-leaseback theoretically involves the purchase of property by a small business, which business would then sell the property, together with the ACRS deductions and investment credits accompanying it, to a large corporation with sufficient tax liability to absorb both the credits and deductions. The large corporation immediately leases the property back to the small business for use in latter's trade or business.

The second, known commonly as the "lease-leaseback" or "ITC Strip," is a variation of the sale-leaseback, the principal difference being that only investment tax credits are transferred. In a typical ITC Strip transaction, property purchased by a small business from a vendor is leased to a large corporation. The ACRS deductions relating to the property are retained by the small business. The investment tax credits are stripped away and transferred to the large corporation, together with the lease. The large corporation immediately leases the property back to the small business, while retaining the benefit of the investment tax credits. ITC Strip transactions are often of advantage to businesses anticipating profitability in the near future, but whose present taxable income does not warrant retention of investment tax credits. Following the enactment of ERTA, it was thought that ITC Strip transactions would be popular among small businesses, since issues relating to indemnification are simpler and the transaction as a whole is less expensive to arrange than a sale-leaseback. Many small businesses looked forward to participating in ITC Strip transactions.

Unfortunately, the IRS reserved to itself the issue of whether § 168(f)(8) leases may be used to transfer only investment tax credits to parties other than the ultimate user of the property involved. The IRS has indicated that such reservation is not intended to suggest that ITC Strip transactions will be permitted under § 168(f)(8). For all intents and purposes, this eliminated the present availability of ITC Strip transactions. At the very least, enthusiasm for this vehicle has been severely dampened, to the detriment of small business.

The final regulations issued by the IRS may or may not offer safe-harbor treatment for ITC Strip transactions. As a consequence, it would be appropriate for Congress to amend § 168(f)(8) in such manner as to clearly indicate safe-harbor treatment for ITC Strip transactions.

3. Extension of the placed-in-service deadline

Under the temporary regulations presently in effect, an agreement shall be eligible for treatment as a § 168(f)(8) lease only if the subject property is leased within three months after it is placed in service. Property is considered placed in service at

the time it exists in a condition or state of readiness and availability for a specially assigned function.

The three-month limitation period should be extended to six months, or preferably, nine months. This would permit newly organized small businesses to accumulate a greater number of capital assets and place itself on firmer financial footing prior to entry into § 168(f)(8) leasing transactions. Assuming that during these additional months a newly organized small business will increase the number of capital assets in service, small businesses will be poised to participate in larger transactions which may be arranged at a lower net cost.

4. Additional at-risk rules

The safe-harbor rules require that at all times during the term of the lease, the lessor must have at-risk a minimum of 10 percent of the adjusted basis of the leased property. This requirement has not hindered utilization of § 168(f)(8) by small business. However, small business interest in safe-harbor leasing has been retarded by the potential applicability of additional "at-risk" rules set forth in §§ 465 and 46(c)(8) of the Internal Revenue Code.

The additional at-risk rules generally apply to individuals, partnerships, subchapter S corporations and closely-held corporations (corporations having five or fewer individual shareholders owning more than 50 percent of the corporation's shares). However, closely-held corporations "actively engaged" in equipment leasing are excluded from the at-risk rules. To be eligible for the exclusion, the corporation must receive 50 percent or more of its gross receipts from equipment leasing. Closely-held corporations not eligible for the exemption are subject to the at-risk rules.

The effect of these rules is to restrict under certain circumstances use of the safe-harbor by closely-held corporations not actively engaged in equipment leasing. In sale-leaseback transactions financed by non-recourse indebtedness, such corporations will not likely be able to purchase ACRS deductions or investment credits since they will be unable to absorb these benefits due to the applicability of the at-risk rules. The application of these additional rules not only eliminates a potential class of lessors, but also indirectly restricts the ability of small businesses to enter into safe-harbor transactions as lessees.

The at-risk rules set forth in §§ 46(c)(8) and 465 should be revised so as to exclude from their coverage all participants in safe-harbor leasing transactions.

5. Short-form safe-harbor

Small business interest in the safe-harbor has clearly been inhibited by the perception that the costs associated with § 168(f)(8) leasing transactions do not vary significantly with the size of the transaction or the parties involved. The feeling persists that if the safe-harbor were made easier and less expensive for small business to take advantage of, small business would perhaps be more inclined to consider leasing as a viable means of making capital expenditures.

In this regard, it is suggested that a prototype lease and documentary package be prepared by the IRS for use in certain specified small leasing transactions, for example, transactions involving property worth less than $500,000. The model lease and supporting documentary package could be utilized with confidence by small businesses wishing to participate in safe-harbor leasing transactions since the IRS would guarantee safe-harbor treatment with respect to any transaction entered into utilizing the model documents. It is hoped that this concept would spur small business interest in the safe-harbor in the same manner that pre-approved pension plan and trust forms spurred interest in retirement planning.

CONCLUSIONS

Although the statute and temporary regulations are not entirely satisfactory from the perspective of small business, repeal or substantial modification of § 168(f)(8); would be a mistake. Legislation aimed at the repeal or substantial modification of § 168(f)(8) has gained momentum in recent weeks in part because of actual and projected revenue losses attributable to safe-harbor leasing. While the revenue loss thus far is higher than had been anticipated, it must be recognized that the shortfall is in large measure more properly attributable to the retroactive provisions of the statute. In retrospect, it was excessive to permit large corporations to retroactively benefit from the safe-harbor, but that does not justify repeal or modification of a statute that promises to be of significant future benefit to small business.

It is far too early to obtain an accurate assessment of the success or failure of § 168(f)(8). As a practical matter, the safe-harbor serves several important purposes. It encourages capital investment by small business. It permits an efficient absorption of excess ACRS deductions and investment tax credits. Additionally, the provi-

sion serves to alleviate concern about the possibility of future mergers and acquisitions occurring solely as a consequence of target companies accumulated tax benefits.

As a matter of policy, §168(f)(8) makes sense. Absent the provision, unprofitable small businesses have little or no incentive to make capital expenditures. By permitting the transfer of tax benefits through safe-harbor leases, small businesses are enabled to take indirect advantage of deductions and credits to which they would otherwise be entitled but for their unprofitability. At the same time, the safe-harbor is politically more appealing than previously considered alternatives permitting the refundability or outright sale of investment credits or ACRS deductions.

Nevertheless, there are loopholes in the statute which deserve to be closed. Under present law, for example, certain large corporations having little or no tax liability by reason of their profit having been earned abroad are able to finance their capital expenditures through use of the safe-harbor even though they are profitable. For several reasons, I suggest that the safe-harbor be made unavailable to corporations with little tax liability but high earnings.

While large corporations have thus far been the principal beneficiaries of safe-harbor leasing, I remain convinced that small business will in the near future begin to take advantage of §168(f)(8). The proposals offered should, if acted upon, facilitate this development. Hopefully, Congress will not repeal or substantially modify the safe-harbor leasing provisions before they have had a chance to work for small business.

Mr. NOWAK. Thank you, Mr. Kriss, for a very detailed, complete, and I must say, a statement that has touched upon some of the other areas which really are very critical to this whole problem.

When we look at a combination of this testimony, we can see a problem in that small business has not had the opportunity, despite the Treasury's statement and their preliminary conclusion to the contrary, and I will call it preliminary just to be very kind, stating that small business is receiving more than their fair share of participation.

If you look at the broad posture, you can see that with either regulatory changes or statutory changes, there is some chance that small business could, in the future, participate on an adequate basis. If the changes that you three gentlemen discussed could be put together, and along with some other changes that could be made to outlaw or eliminate the outrageous advantages that were taken by some of the larger corporations under this act and if we could put all that together in as short as possible time, perhaps we would have an incentive that small business could use. This would certainly be what I think at least some of the congressional intent was when all of this was considered last year.

I thank each of you for your very complete and very detailed testimony that I think we can summarize and bring to the attention of many others in the Congress. I think this is the first opportunity people really had to get into the nuts and bolts of this, and I really want to compliment each of you for your participation. There will be, I believe, further discussion. Let me at this time see if my colleague Mr. Roemer from Louisiana, who has patiently sat with us, has any particular questions he would like to ask of this panel.

Mr. ROEMER. Briefly, Mr. Chairman, and I thank you. I, too, want to add my thanks for the testimony. It was excellent. Without reservation, it was excellent and informative.

Let me respond to a couple of, I thought, telling points. Obviously, you have pointed out, each of you, from your perspective on the world, the impediments in this law to equity in terms of its applicability to small and larger business, and I think the points were well made.

I would like to respond to a couple of things that were said, first of all about the gentleman from Leasemakers, I think it is, who made a good statement and pointed out quite candidly that when one talks of tax losses or tax expenditures, as we say here, that in effect it might be a loss today, but it is a tax deferral. The economic activity therefrom will mean something in the future; no question about that. I will respond by saying that I am not ready to say that Reaganomics is bankrupt, but it sure as hell has a cash-flow problem. So today's cash expenditure is very important to us.

A second point, the accounting gentleman, Mr. Padwe, made was the point that certainly, the ability to plan is important in business considerations, particularly important for small business, that often survives by its wit and its planning capability rather than its large resources. I think that is a point well made, and it would be not a healthy thing in midstream to reverse course, to flip-flop, as you so well put. But to help you in your planning, plan for this provision to be stricken from the law.

Finally, I would say that each of you has made a good case on how changes in the law through mandates could be improved. You have suggested corrective surgery here; I am suggesting euthanasia.

Thank you.

Mr. NOWAK. Thank you very much, and once again, let me just restate that we have this basic material you presented, and hopefully we can interest others to try to digest this information in some detail as it was presented. At that point in time, we may request some other detail, some other part of the question, and we may have to get back to you to derive some of the expertise in various areas that you talked about here.

I really, once again, want to thank you for coming, because this, I think, was a very good session that will get some intelligent debate on this whole question to the Congress. We will have to be looking at what happens as we get more detail from Treasury, and your presentation, especially on behalf of small business is very, very much appreciated. Thank you very much for attending.

I would like to announce we have three more presentations, and what I would like to do is—we are going to have to leave this room in any event shortly—take a recess until 1:30, and then we will be able to come back into the small hearing room, which is 2359–B, at 1:30. It is to the left of us here, and we will conclude that last panel at that time.

Thank you very much for attending, and the subcommittee stands in recess until 1:30.

[Whereupon, at 11:50 a.m., the subcommittee adjourned, to reconvene at 1:30 p.m.]

AFTERNOON SESSION

Mr. NOWAK. The subcommittee will come to order.

We have three of our more astute business groups in this country present, and if we would be able to panel the representatives of this group once again: First, we have the National Association of Wholesaler-Distributors represented by John Fitch, Jr., if he would come forward. He is vice president for government relations of the

association. Also, the National Federation of Independent Businesses with Gwen Pritchard who is the legislative representative, accompanied by Abraham Schneier who is tax accountant and research director there. The third is the National Small Business Association, represented by Mr. James McCarthy, who is the vice president for tax and business services for General Business Services, Inc., and he is appearing on behalf of NSBA.

Gentlemen, welcome, and thank you for your patience. It has been a little hectic today. We start out then in the order you were called, although it doesn't make much difference.

Mr. Fitch?

PANEL CONSISTING OF JOHN H. FITCH, JR.; GWEN PRITCHARD; AND JAMES D. McCARTHY

TESTIMONY OF JOHN H. FITCH, JR., VICE PRESIDENT, GOVERNMENT RELATIONS, NATIONAL ASSOCIATION OF WHOLESALER-DISTRIBUTORS

Mr. FITCH. Thank you, Mr. Nowak.

I think I will summarize my statement and submit the entire statement for the record in the essence of time.

Mr. NOWAK. Without objection, it certainly will be included, as will all the other statements.

Mr. FITCH. NAW would like to strongly support the leasing provisions of the Tax Act and its potential cash-flow benefits for wholesaler-distributors. They are the ones who suffer most from the erosion of operating and growth capital from high interest rates and inflation.

However, as interpreted by the Treasury Department through its October 20, 1981 temporary regulations, closely held wholesaler-distributors are limited as lessors by the at-risk rule of section 465 of the Internal Revenue Code. This application, in NAW's view is administrative in origin and was a conscious decision by the Treasury Department to limit leasing to larger companies. In that regard, we certainly agree with the representative from the AICPA that this is an administrative application rather than a statutory application.

Further, NAW believes the Treasury Department can administratively reverse that restriction rather than requiring a legislative resolution as Treasury this morning indicated. In fact, NAW believes the 465 provision in general should be examined. It is another example of how small business is hampered and prejudiced by the Tax Code generally in its efforts to become profitable.

In that regard, we advocate the following solutions to the 465 problem: That the Treasury Department administratively correct the at-risk application to lessors; or, that the Treasury Department publicly support a statutory amendment exempting the application of 465 rules to closely held lessors which it would appear the Treasury Department, based on Mr. Glickman's statement this morning, is not ready to do.

I might also add that if legislative activity is required, we think the Technical Corrections Act to the Economic Recovery Tax Act, might be an appropriate vehicle.

NAW believes that the failure to correct this problem will result *in the following:* Continued denial to affected wholesaler-distributors of an affordable marketplace capital formation mechanism to counter the ravages of high interest rates and inflation which will keep them productive, and in many cases in business. Failure to do that could result in significant negative economic consequences. Finally, the causal reduction in the pool of buyer-lessors for small businesses who are seller-lessees, renders the usefulness of safe harbor leasing for small business to a minimum.

In deference to what Mr. Glickman said this morning, we would agree with some of the comments made by members of the subcommittee that while Treasury says that leasing is being used by small business, they have no idea what small business is or how it is defined.

Finally, I would like to refer you to the back of my testimony which has a handy-dandy chart which illustrates how the at-risk application of safe harbor leasing affects both the lessee and the lessor, and how, in its present form, leasing is extremely uneconomical and therefore useless to small business.

With that, I will just end my statement.

[Mr. Fitch's prepared statement follows:]

PREPARED STATEMENT OF JOHN H. FITCH, JR., VICE PRESIDENT, GOVERNMENT RELATIONS, NATIONAL ASSOCIATION OF WHOLESALER-DISTRIBUTORS

SUMMARY

On behalf of the National Association of Wholesaler-Distributors' 121 member national associations and their aggregate 45,000 member companies, we strongly support the leasing provision of the Economic Recovery Tax Act and its potential cash flow benefits for wholesaler-distributors who suffer most the erosion of operating and growth capital from high interest rates and inflation.

However, as interpreted by the Treasury Department through its October 20, 1981, temporary regulations, closely-held wholesaler-distributors are limited (as lessors) by the "at risk" rule of Section 465 of the Internal Revenue Code.

This application, in NAW's view, is administrative in origin and was a conscious decision by the Treasury Department to limit leasing to larger companies.

We believe the Treasury Department can administratively reverse that restriction rather than requiring a legislative resolution as Treasury advocates is necessary.

NAW advocates the following solutions to the problem:

(1) that Treasury Department administratively remove the application of the Section 465 "at risk" rules to closely-held lessors by amending Temporary Regulation Section 5c.168(f)(8)-7(f); or

(2) that Treasury Department publicly support a statutory amendment to Section 168(f)(8) exempting the application of the Section 465 "at risk" rules to closely-held lessors; or

(3) provide a technical amendment to the Technical Corrections Act to exempt closely-held lessors from the application of the Section 465 "at risk" rules.

Failure to correct this problem will result in the following:

(1) continued denial to affected wholesaler-distributors of an affordable, marketplace capital formation mechanism to counter the ravages of high interest rates and inflation and to keep them productive and, in many cases, in business could result in significant negative economic consequences; and

(2) causal reduction in the pool of buyer/lessors for small business seller/lessee, rendering the usefulness of safe-harbor leasing for small business at a minimum.

FULL STATEMENT

Mr. Chairman, Members of the Subcommittee, this statement is presented on behalf of the wholesale distribution industry by the National Association of Wholesaler-Distributors. My name is John H. Fitch, Jr., Vice President-Government Relations for NAW.

The National Association of Wholesaler-Distributors is a federation of 121 national wholesale distribution associations which have an aggregate membership of approximately 45,000 wholesaler-distributors, with 150,000 places of business (see attached list).

The members of our constituent associations are responsible for 60% of the $1 trillion of merchandise which will flow through wholesale channels this year, according to the Commerce Department. They employ a comparable percentage, or 3 million, of the 5 million Americans who work in wholesale trade.

Although the individual firms which our organization represents are small- to medium-sized businesses individually, their collective economic importance is most significant.

THE INDUSTRY

The wholesale distribution industry, in contrast to the manufacturing sector of the economy, continues to be dominated by small- to medium-sized, closely-held, family-owned businesses. Of the 238,000 merchant wholesaler-distributor corporations filing tax returns in 1977, 99% had assets of $10 million or less. These smaller firms accounted for about 58% of the industry's sales volume. In contrast, in the manufacturing sector, approximately 2% of the firms controlled about 88% of the assets and accounted for approximately 80% of sales.

The wholesale distribution industry provides year-round employment for over 5 million individuals. In 1977, average hourly earnings ($6.78) in wholesale trade exceeded those for all private industry ($5.14), while average weekly earnings ($212) were 15% above those in private industry ($185). In short, the wholesale distribution industry provides dependable, well-paying jobs throughout the U. S. economy.

A 1981 profile of the wholesale trade, as compiled by the U. S. Department of Commerce from Census Bureau figures, shows the following:

SIC CODES: 50-51

Sales (million $)	955,175
Employment (000)	5,280
Number of establishments (1977)	307,264
Compound annual rate of change, 1975-80:	
Sales (percent)	12.3
Employment (percent)	3.6
Payroll (million $)	72,000

Merchant wholesaler-distributors perform an essential economic function. They make goods and commodities of every description available at the place of need, at the time of need. Wholesaler-distributors purchase goods from producers, inventory these goods, break bulk, sell, deliver, and extend credit to retailers and industrial, commercial, institutional, governmental and contractor business users.

Wholesaler-distributors are essential to the efficient satisfaction of consumer and business needs. Further, by the market coverage which they offer smaller suppliers and the support which they provide to their customers, wholesaler-distributors preserve and enhance competition, the critical safeguard of our economic system. According to an NAW survey, the typical wholesaler-distributor established the market connection between 133 manufacturers and 533 business customers. Many of these manufacturers are themselves small businessmen who must rely on wholesaler-distributors to establish, maintain, and nurture

markets for their products. The majority of customers are small businessmen, also, who look to the merchant wholesaler-distributor to provide merchandise availability, credit and other critical services.

BACKGROUND

In his testimony before the House Appropriations Committee on February 9th, Secretary Regan stated that small and new businesses will benefit from the safe-harbor leasing provisions of Economic Recovery Tax Act of 1981 and that this circumstance was intended. He indicated small and new businesses which generally cannot use tax credits because thay have negligible earnings can, in fact, use leasing as a means to obtain needed cash flow.

However, the application of the "at risk" provisions to leasing transactions effectively precludes many small and medium-sized operating corporations from full utilization of these provisions.

As amended by the Economic Recovery Tax Act of 1981, Section 168(f)(8)(B)(i) of the Internal Revenue Code states that in order to be a lessor under the safe-harbor leasing provisions, a lessor must be:

(1) a corporation, other than a Subchapter S corporation or a personal holding company;

(2) a partnership, all the partners of which are qualifying corporations; or

(3) a grantor trust, the grantor and all of the beneficiaries of which are either qualified corporations or qualified partnerships.

The lessee, however, may be any of the above, including a subchapter S corporation partnership or individual holding company. The stated purpose of the statute is to provide a cash flow mechanism by which a lessee company in a loss position can receive present value for tax benefits received under ACRS but which are unusable by him in the current year.

Moreover, it provides tax relief for marginal companies who also need a cash flow boost.

With high interests rates and inflation eroding the profits wholesaler-distributors use for operations, growth and payroll, leasing provides a valuable marketplace capital formation mechanism to keep these companies productive and, in many cases, in business.

There is no question that safe-harbor leasing overrides the fundamental principles of tax law which look to the substance rather than the form to determine the real nature of the transaction (for tax purposes).

However, Congress and the Administration have made a conscious decision in this instance that the immediate cash flow needs of marginal or loss companies who are placed in that condition by high interest rates and inflation rather than poor management are more important than traditional tax law principles. Moreover, it is a marketplace fix rather than a government fix. The disruption of the economy in terms of employment, distribution channels, and productivity should these companies fail would be significant.

Moreover, the vulnerability of these small businesses to mergers and acquisitions would significantly increase as the tax benefits of ACRS began to accumulate over time. This would lead to further concentration based on tax decisions rather than competitive reasons; bad public policy to say the least.

Under Temporary Regulation Section 5c.168(f)(8)-7(f), issued by the Treasury Department on October 20, 1981, the amount of investment tax credit and ACRS deductions allowed to a lessor with respect to leased property is limited to the extent the "at-risk" rules under the investment tax credit provisions and Section 465 apply to the lessee or lessor.

Section 465 applies to corporations which have more than 50% of the value of their outstanding stock owned, directly or indirectly, by not more than five individuals. Thus, under the regulations, these companies would not be able to "buy" property (i.e., unused ITCs and ACRS deductions) in a sale/lease-back transaction financed by nonrecourse indebtedness because they would not be considered "at risk" to the extent of such amounts.

While the Act authorizes the Secretary of Treasury to prescribe regulations necessary to carry out the purposes of the safe-harbor leasing provisions, including limits on the amounts and timing of deductions, it does not specifically apply the Section 465 "at-risk" rules to leasing.

The practical effect of that one provision of the regulations is to arbitrarily exclude a major segment of the business community from the benefits of safe-harbor leasing -- namely, small business -- which needs it the most.

It is a fact that small business is extremely dependent on debt financing as opposed to equity financing for its operating and growth capital. Thus, high interest rates over a sustained period of time have a disastrous effect on these companies.

They are immediately thrown into a marginal or loss position by external forces not of their making.

Safe-harbor leasing is designed to assist these businesses. But the Treasury regulations effectively take it away.

By applying the 465 at-risk rules to nominal lessors, Treasury has eliminated the number of buyers available for small business lessees. This further reduces their ability to utilize safe-harbor leasing as a means of obtaining affordable capital.

As a general rule, small business lessors are the most likely "buyers" for small business lessee tax benefits. Therefore, by arbitrarily reducing that buyer pool, the sellers have less opportunity to utilize the safe-harbor leasing provisions.

The application of the 465 at-risk rules by Treasury to nominal lessors was discretionary and makes no practical sense so long as the lessor is an operating corporation and can buy through a 168(f)(8) transfer only those credits and depreciation allowances available to the lessee.

TREASURY POSITION

To say that the Treasury Department has been inconsistent with regard to its position on this issue is an understatement.

In a speech before the Tax Society of New York University on October 5, 1981, Assistant Secretary for Tax Policy John Chapoton stated:

". . . a purchaser of tax benefits under a safe-harbor lease will not be limited by the "at risk" rules from claiming the credits and deductions that would have been available to the lessee." (emphasis added)

Mr. Chapoton went on to say:

"What tax leasing guarantees is that the investment stimulus of ACRS will be available equally to all firms which make new investments . . . " (emphasis added)

"Far from being a special interest benefit for distressed industries or cash rich companies, leasing is a tool for spreading the investment stimulus of the new tax law more equally throughout the economy." (emphasis added)

On December 16, 1981, Dennis Thomas, Assistant Secretary for Legislative Affairs at Treasury, wrote the following to Senator Nunn (D-GA), ranking minority member of the Senate Small Business Committee:

"Although the leasing rules generally do not expressly preclude (small companies) from engaging in leasing transactions, the regulations do provide that the at risk rules apply in determining the amount of deductions and credits a lessor may deduct." (emphasis added)

NAW POSITION

NAW strongly supports the elimination of the application of the Section 465 "at-risk rules" to lessors under the safe-harbor leasing provisions.

The bias against closely-held corporations is neither justified nor supportable by the facts. It arbitrarily precludes an important segment of the business community from utilizing the safe-harbor leasing provisions. These firms are also the ones most affected by the cash flow erosion of inflation and high interest rates.

Elimination of the ability of closely-held corporations to use the safe-harbor leasing provisions also alienates a significant segment of the business community (with tremendous grass roots strength) from the leasing support base. Moreover, it gives credence to the notion that leasing is for big business only.

The application of the Section 465 "at-risk" rules to lessors makes closely-held corporations less desirable as potential lessees because potential buyer/lessors who are not bound by the Section 465 rules would, nonetheless, be limited by them via their application to the lessee.

Moreover, it would unnecessarily limit the pool of buyers for small business tax benefit sellers.

Finally, NAW, senior tax staff of Finance Committee members, and other knowledgeable leasing tax specialists agree with the premise that Treasury could administratively eliminate the problem by amending its temporary regulations. We are not convinced, as is the Treasury staff, that legislative resolution is necessary.

As you well know, the leasing provision is extremely vulnerable politically; therefore, early resolution of the problem is essential if small, closely-held corporations are to benefit from safe-harbor leasing and, consequently, support its retention.

RECOMMENDATIONS

(1) That the Treasury Department amend its October 20, 1981, Temporary Regulations to eliminate the application of Section 465 of the Internal Revenue Code to safe-harbor leasing; or

(2) that the Treasury Department publicly support legislation to eliminate the application of the Section 465 at-risk

rules to safe-harbor leasing if an administrative solution is not forthcoming; or,

(3) that the Treasury Department initiate or support a technical amendment to the Economic Recovery Tax Act Technical Corrections Act that would eliminate the application of Section 465 of the Internal Revenue Code to safe-harbor leasing.

Mr. Chairman, that concludes my statement. I would be happy now to respond to any questions you or members of the Subcommittee might have.

IMPACT OF "AT RISK" RULES ON SAFE HARBOR LEASING

DATA

Machine Cost = $100,000
10% Investment Tax Credit = $ 10,000
First Year ACRS Depreciation = $ 30,000
Cost Recovery Period = 5 years

SAFE HARBOR LEASING
(without at-risk application)

Wholesaler-Distributor A = Seller/Lessee — **Wholesaler-Distributor B = Buyer/Lessor**

$10,000 ITC
$30,000 Depreciation → unusable by A → applied against taxable income

$10,000 ← 10% of basis (minimum) ← cash for sale

$10,000 cash (present value) ← RESULT → reduced tax income by $40,000

* * * * *

SAFE HARBOR LEASING
(with at-risk application)

Wholesaler-Distributor A = Seller/Lessee — **Wholesaler-Distributor B = Buyer/Lessor**

$ 1,000 ITC
$ 3,000 Depreciation → unusable by A → applied against taxable income

$10,000 ← 10% of basis (minimum) ← cash for sale

$10,000 cash (present value) ← RESULT → reduced taxable income by $4,000

* * * * *

SAFE HARBOR LEASING
(with at-risk applied to lessor)

Wholesaler-Distributor A = Seller/Lessee — **Wholesaler-Distributor B = Buyer/Lessor**

$10,000 ITC
$30,000 → unusable by A → $4,000 applied to taxable income

$10,000 ← 10% of basis (minimum) ← cash for sale

$10,000 cash (present value) ← RESULT → reduced taxable income by $4,000

* * * * *

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National Wholesaler-Distributor Organizations Affiliated with the National Association of Wholesaler-Distributors

Air-conditioning & Refrigeration Wholesalers
American Dental Trade Association
American Jewelry Distributors Association
American Machine Tool Distributors' Association
American Supply Association
American Surgical Trade Association
American Traffic Services Association
American Veterinary Distributors Association
Appliance Parts Distributors Association, Inc.
Associated Equipment Distributors
Association of Footwear Distributors
Association of Steel Distributors
Automotive Service Industry Association
Aviation Distributors & Manufacturers Association

Bearing Specialists Association
Beauty & Barber Supply Institute, Inc.
Bicycle Wholesale Distributors Association, Inc.
Biscuit & Cracker Distributors Association

Ceramic Tile Distributors Association
Ceramics Distributors of America
Coated Abrasives Fabricators Association
Cooperative Food Distributors of America
Copper & Brass Servicenter Association
Council for Periodical Distributors Association
Council of Wholesale-Distributors
American Institute of Kitchen Dealers

Distributors Council, Inc.
Door & Hardware Institute
Drug Wholesalers Association

Electrical-Electronics Materials Distributors Assn.
Explosive Distributors Association, Inc.

Farm Equipment Wholesalers Association
Flat Glass Marketing Association
Fluid Power Distributors Association, Inc.
Food Industries Suppliers Association
Foodservice Equipment Distributors Association

General Merchandise Distributors Council

Hobby Industry Association of America

Independent Medical Distributors Association
The Irrigation Association
Institutional & Service Textile Distributors Association, Inc.
International Ceramic Association

Machinery Dealers National Association
Mass Merchandising Distributors Association
Material Handling Equipment Distribution Association
Monument Builders of North America-Wholesale Div.
Motorcycle Industry Council
Music Distributors Association

National-American Wholesale Grocers' Association
National Appliance Parts Suppliers Association
National Association of Aluminum Distributors
National Association of Chemical Distributors
National Association of Container Distributors
National Association of Decorative Fabric Distributors
National Association of Electrical Distributors
National Association of Fire Equipment Distributors
National Association of Floor Covering Distributors
National Association of Manufacturing Opticians
National Association of Marine Services, Inc.
National Association of Meat Purveyors
National Association of Plastics Distributors
National Association of Recording Merchandisers, Inc.
National Association of Service Merchandising
National Association of Sporting Goods Wholesalers
National Association of Textile & Apparel Distributors
National Association of Tobacco Distributors
National Association of Writing Instrument Distributors
National Beer Wholesalers Association
National Building Material Distributors Association
National Business Forms Association
National Candy Wholesalers Association
National Commercial Refrigeration Sales Association
National Electronic Distributors Association
National Fastener Distributors Association
National Food Distributors Association
National Frozen Food Association
National Independent Bank Equipment Suppliers Assn.
National Industrial Belting Association
National Industrial Glove Distributors Association
National Lawn & Garden Distributors Association
National Locksmiths' Suppliers Association
National Marine Distributors Association
National Paint Distributors, Inc.
National Paper Trade Association, Inc.
National Plastercraft Association
National Sash & Door Jobbers Association
National School Supply & Equipment Association
National Solid Wastes Management Association
National & Southern Industrial Distributors Associations
National Spa and Pool Institute
National Truck Equipment Association
National Welding Supply Association
National Wheel & Rim Association
National Wholesale Druggists' Association
National Wholesale Furniture Association
National Wholesale Hardware Association
Northamerican Heating & Airconditioning Wholesalers
North American Wholesale Lumber Association, Inc.

Optical Laboratories Association
Outdoor Power Equipment Distributors Association

Pet Industry Distributors Association
Petroleum Equipment Institute
Power Transmission Distributors Association, Inc.

Safety Equipment Distributors Association, Inc.
Scaffold Industry Association
Shoe Service Institute of America
Specialty Tools & Fasteners Distributors Association
Spring Service Association
Steel Service Center Institute

Textile Care Allied Trades Association
Toy Wholesalers' Association of America

United Pesticide Formulators & Distributors Association

Wallcovering Distributors Association
Warehouse Distributors Association for Leisure & Mobile Products
Watch Materials & Jewelry Distributors Association
Water and Sewer Distributors Association
Wholesale Florists & Florist Suppliers of America
Wholesale Stationers' Association, Inc.
Wine & Spirits Wholesalers of America, Inc.
Wood Heating Alliance
Woodworking Machinery Distributors Association

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Mr. NOWAK. Thank you very much. I think you touched on some very good detail in your written statement. Also I think it vividly shows what could be accomplished here.

Let me pass on to our next witness, and then perhaps we can get into a general discussion of a couple of overlying concerns that we have. Let's have Gwen Pritchard from the National Federation of Independent Business.

TESTIMONY OF GWEN PRITCHARD, LEGISLATIVE REPRESENTATIVE, NATIONAL FEDERATION OF INDEPENDENT BUSINESS, ACCOMPANIED BY ABRAHAM SCHNEIER, TAX COUNSEL, RESEARCH DEPARTMENT

Ms. PRITCHARD. Thank you, Mr. Chairman.

I am not Mike McKevitt as the prepared statement indicates. Mr. McKevitt wishes me to express his apologies to you for having to remain in California at our home office, preventing him from being with you today. I am accompanied by the tax counsel on our research staff.

Mr. NOWAK. I might just mention, I read some of Mr. McKevitt's thoughts in the Post this morning. Very happy to see it. Go ahead.

Ms. PRITCHARD. As I mentioned, I have Abraham Schneier with us today who is our tax counsel in the research department.

I do want to thank you for letting us testify on this issue; it is something that is of concern to us. As you mentioned earlier, the safe harbor lease election was included in the Economic Recovery Tax Act of 1981 to assist those firms who would be able to take advantage of the new incentives under the ACRS, but might not be able to take full advantage of the credits and deductions in the current year.

There is one piece of background information I would like to bring forward as far as our membership is concerned in this whole area: Under the old law, leasebacks were narrowly defined to prevent a safe harbor lease transaction from taking place. The lessor had to be concerned about the transaction, that it would not be characterized by IRS as a sale or financing. If IRS did recharacterize a transaction, the tax effects were substantial, since the payments and the tax benefits derived from the payments are altered.

Refundability of the investment tax credit—ITC—a concept which has been discussed since the inception of the ITC, accomplishes a similar purpose as safe harbor leasing. Supporters of refundability argue that a firm which cannot obtain a current benefit from a credit has a diminished economic value. However, the effect is to promote a direct subsidy to ailing industries through the ITC, certainly a topic that deserves special attention and congressional deliberation.

In the past, however, the membership of NFIB has voted against allowing refundability of the ITC because of the subsidy aspect of the proposal. While some might argue that safe harbor leasing rules are fairer to those involved in the transaction, in truth it opens up tax policy considerations that were not considered when the proposal was adopted. With this situation as a backdrop, the membership of NFIB was asked the following question in a recent

"mandate:" Do you favor or oppose keeping the leaseback provisions of the recently enacted tax reduction bill?

The results were 27 percent in favor of retaining those provisions, and 63 percent opposed retaining them; 10 percent remained undecided. The vote is not surprising, since small business was not a beneficiary of the rule, and is totally consistent with the earlier vote in opposition to the refundable investment tax credit. Based on these votes, the NFIB will work for the repeal of the safe harbor leasing provisions in the ERTA. We agree with a recent Wall Street Journal editorial, "New Lease on Losers," that this provision in ERTA promotes an unnecessary subsidy for those corporations who are losing money.

Certainly elimination of the cost of the safe harbor leasing rules, which is estimated at $29 billion for years 1981 through 1986, will be very helpful in efforts to reduce the tremendous 1983 budget deficits. High interest rates are having, as you well know, a devastating impact on small business. High deficits and high interest rates continue to be the major problems Congress must deal with. Recent high deficit estimates were closely followed by increases in the prime rate at a time of general economic recession.

In conclusion, NFIB supports the repeal of the safe harbor leasing rules and strenuously disagrees with the Treasury Department that repeal of leasing hurts the possibilities for economic recovery. The portions of the tax bill that do promote economic recovery and which are of the greatest aid to small business are the individual rate cuts and ACRS provisions in ERTA.

Thank you.

[Mr. McKevitt's prepared statement follows:]

PREPARED STATEMENT OF JAMES D. "MIKE" MCKEVITT, DIRECTOR OF FEDERAL LEGISLATION, NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Mr. Chairman, I am James D. "Mike" McKevitt, Director of Federal Legislation for the National Federation of Independent Business (NFIB) and accompanying me is Abraham Schneier of our research staff. On behalf of NFIB's 500,000 members, I would like to thank you for allowing me to express our membership's views on the subject of Safe Harbor Leasing.

The Safe Harbor Lease election was included in the Economic Recovery Tax Act (ERTA) of 1981 to assist those firms who would be taking advantage of the new incentives under ACRS but might not be able to take full advantage of the credits and deduction in the current year. Under the old law this type of transaction, a leverage lease, had to meet very strict IRS guidelines. The guidelines were established to insure that an economic reason for the transaction existed and that tax benefit was not the only reason for the lease.

The guidelines were:

1. The lessor, at all times, must have a minimum "at risk" investment in the asset of at least 20 percent of its cost;
2. The lessor must be able to show that the transaction was entered into for profit, apart from the transaction's tax benefits (i.e., without consideration of the tax deductions, allowances, credits, and other tax attributes arising from the transaction);
3. The lessee must not have a contractual right to purchase the property at less than its fair market value, nor may the lessor have a contractual right to cause any party to purchase the asset;
4. The lessee may not have furnished any part of the purchase price of the asset nor have loaned or guaranteed any indebtedness created in connection with the acquisition of the property by the lessor; and
5. The use of the property at the end of the lease term by a person other than the lessee must be commercially feasible to the lessor.

The new rules great facilitated a leverage lease by allowing a safe harbor wherein a lessee and lessor simply must elect to have a transaction treated as a lease, with only three qualifications:

1. The lessor must be a corporation other than a subchapter S or closely held corporation;
2. The lessor must have a minimum 10 percent "at risk" investment in the equipment; and
3. The term of the lease cannot exceed a period equal to the ADR midpoint life of the property.

If a transaction meets these three requirements, the transaction will not be scrutinized to determine if the transaction is a sale, a lease, a financing or something else. Therefore, the following factors become irrelevant to the characterization of the transaction:

1. The link between tax benefits of ownership and profit;
2. The general burdens and benefits of ownership; or
3. The existence of a bargain purchase option.

Under the old law, leasebacks were narrowly defined to prevent a safe harbor lease transaction from taking place. The lessor had to be concerned that the transaction would not be characterized by IRS as a sale or a financing. If IRS did recharacterize a transaction, the tax effects were substantial, since the payments and the tax benefits derived from the payments are altered.

Refundability of the investment tax credit (ITC), a concept which has been discussed since the inception of the ITC, accomplishes a similar purpose as Safe Harbor Leasing. Supporters of refundability argue that a firm which cannot obtain a current benefit from a credit has a diminished economic value. However, the effect is to promote a direct subsidy to ailing industries through the ITC, certainly a topic that deserves special attention and congressional deliberation.

In the past, the membership of the NFIB has voted against allowing refundability of the ITC because of the subsidy aspect of the proposal. While some might argue that safe harbor leasing rules are fairer to those involved in the transaction, in truth it opens up tax policy considerations that were not considered when the proposal was adopted.

CONCLUSIONS

With this situation as a backdrop, the membership of NFIB was asked the following in a recent mandate:

"Do you favor or oppose keeping the lease-back provision of the recently enacted tax reduction bill?"

The results were 27 percent in favor, 63 percent opposed and 10 percent undecided. The vote is not surprising, since small business was not a beneficiary of the rule, and is totally consistent with the earlier vote in opposition to the refundable investment tax credit.

Based on these votes, the NFIB will work for the repeal of the Safe Harbor Leasing provisions in ERTA. We agree with a recent Wall Street Journal editorial [1] "New Lease on Losers," that this provision in ERTA promotes an unnecessary subsidy for those corporations who are losing money.

Certainly elimination of the cost of the safe harbor leasing rules, which is estimated at $29 billion for years 1982 thru 1986, would be very helpful in efforts to reduce the tremendous 1983 budget deficits. High interest rates are having a devastating impact on small business. High deficits and high interest rates continue to be the major problems Congress must deal with. Recent high deficit estimates were closely followed by increases in the prime rate at a time of general economic recession.

In conclusion, NFIB supports the repeal of the Safe Harbor Leasing rules and strenuously disagrees with the Treasury Department that repeal of leasing hurts the possibilities for economic recovery. The portions of the tax bill that do promote economic recovery and which are of the greatest aid to small business are the individual rate reduction and ACRS provisions in ERTA.

Mr. NOWAK. Mr. James McCarthy is vice president for tax and business services for General Business Services, Inc., and I understand you are appearing here on behalf of the National Small Business Association.

[1] Wall Street Journal, Feb. 19, 1982.

TESTIMONY OF JAMES D. McCARTHY, VICE PRESIDENT FOR TAX AND BUSINESS SERVICES, GENERAL BUSINESS SERVICES, INC., ON BEHALF OF THE NATIONAL SMALL BUSINESS ASSOCIATION

Mr. McCARTHY. Good afternoon. My name is Jim McCarthy. I am vice president of General Business Services, Inc., in Rockville, Md. I am appearing here today on behalf of the NSBA, which is a multi-industry trade association representing about 50,000 small businesses.

General Business Services is a firm that operates through approximately 1,200 franchised business counselors located throughout the United States, and through these business counselors, with our support from Rockville, Md. we offer tax, tax counseling, and recordkeeping support to small businesses in all 50 States. Our clients are at the smallest spectrum of the small business community, representing professionals, small retailers, Century 21 real estate offices, Farrell's ice cream parlors, and so on. We do not publicize our exact clientele, but we service many, many thousands of small businesses, and to the best of my knowledge, none of these small businesses have taken advantage of the new leasing provisions. To the best of my knowledge, none of the members of the NSBA have to date taken advantage of the leasing provisions. The position of the NSBA is in our statement which I would ask to be included in the record.

Mr. NOWAK. Without objection, it will be so.

Mr. McCARTHY. Simply stated, it states that there are some impediments in the existing law that may be in the statute or may be in the regulations or may be in a combination or may be in our interpretation of the regulations. But whatever they are, they have created an impediment to small businesspersons taking advantage of these leasing provisions, and they should be changed. If they are not changed, then it would be our position that the entire leasing provision should be dropped.

The next interesting question is, if the changes are made, what will be the real impact on the small business community. We at GBS made a little informal service ourselves of reputable brokers who are offering these deals to get some information as to whether we could offer these deals through our own clients. Those that I talked to mentioned that they had written several $100,000 or $200,000 deals, but most of the brokers were stating that at this time you needed about half a million dollar proposition before this would be even usable. The cost may go down as the lawyers and the agents become more familiar with the mechanics, but right now it is a very expensive thing to set one of these up, and they are not writing small deals, and I am greatly suspicious of the statistics that the Treasury submitted. I think when they look at those again, they are going to find they have some mistakes in there.

There is a new reporting form, the number of which escapes me. It is 23 something or other, that must be filed by persons who have made use of this technique. My guess is that they are using these forms for the basis of their statistics, and my guess is that a lot of people have filed them inaccurately. People who have entered into leases to lease xerox equipment or something along that line have

sent this form in when they really don't fit into this area at all, just plain old leases from major manufacturers.

There's approximately 2,200,000 corporate tax returns filed as of 1979, and 90 percent of these have assets of less than $1 million. Half of these have assets of less than $100,000. So if you needed a deal, even a quarter of a million dollar deal, if you look at the spectrum of businesses that are out there, why 70 or 80 percent of them are never going to be eligible. They are just not large enough to get involved in one of these leasing operations. Some of the larger ones will, but the big percentage of the true small businesses will not. Right now, the prime need of small businesses is not new tax legislation. We have given them enough goofed up tax legislation as it is. Right now what they need are lower interest rates, and if this leasing provision increases the deficit and keeps the interest rates up, why it is counterproductive to their major need.

Years ago 30 percent of our tax revenue came from corporations. It is now down to 10 percent or less. We are relying more and more for tax revenue from individuals. There is a tremendous distrust from individuals out there right now for our tax system. We have the infamous underground economy, and there hasn't been a piece of legislation come along in many, many years that has created more distrust than these leasing provisions. The press has distorted it in some ways, but the common small business person and the common working guy looks at this as being an example of how the rich guys are taken care of and the poor guys are getting the short end of the stick.

One thing was mentioned by the chairman this morning as an alternative that we have thought of, and that is if we can't straighten these rules up so that they will pour dollars down to the small business community, a change in the investment credit rules might work. A refundable investment credit would pump some dough into the small business community.

In short, there are a lot of people out there that feel that the entire act should be dropped, but we are not in a position to go that far right now. We haven't polled our members. I personally believe that the act should be suspended. It is tied into ACRS. We all considered ACRS at great length; we studied its pros and cons, but we didn't study the leasing provisions at all. They were snuck through. They were hidden in the law, and we really don't have as much knowledge as we should as to whether they are beneficial or not, and I would vote for a suspension, maybe a 90-day to 6-month suspension with a study and then reactivate it entirely, partially, or drop it completely.

Thank you for the chance to speak to you.

[Mr. McCarthy's prepared statement follows:]

PREPARED STATEMENT OF JAMES D. MCCARTHY, VICE PRESIDENT FOR TAX AND BUSINESS SERVICES, GENERAL BUSINESS SERVICE, INC. ON BEHALF OF THE NATIONAL SMALL

Good Morning. My name is James D. McCarthy. I am Vice President of General Business Services, Inc., Rockville, Md. I am appearing here today on behalf of the National Small Business Association (NSBA), a multi-industry trade association founded in 1937 which has grown to include about 50,000 small businesses nationwide.

INTRODUCTION

The National Small Business Association believes that Congress clearly intended small and closely-held companies to participate in the safe harbor leasing provisions of the Economic Recovery Tax Act. However, we can report to this Subcommittee that the "at-risk" rules make such transactions economically impractical. Therefore, unless there are changes in the law, a significant group of taxpayers will be excluded from participating in a program intended to stimulate the economy.

We were among the earliest of the small business groups to express disappointment about this exclusion. Other small business associations share this view.

Accordingly, we urge that, as a minimum, the Safe Harbor Leasing Provisions be immediately reconsidered by the Treasury Department and that the Congress proceed with dispatch to enact the changes Treasury does not believe it can make in order to give small business a fair opportunity to participate in these transactions as they are and will be structured.

At a January 22, 1982 meeting called by the Senate Small Business Committee Financial and Tax Analyst to discuss an agenda for 1982, safe harbor leasing was the major topic. One national association stated that approximately $30 billion involved in leasing could be better deployed elsewhere to serve the interest of small business.[1]

As you are well aware, Chairman of the Senate Finance Committee, Sen. Dole, has now expressed his intention to modify these provisions. (Press Release of Feb. 19, 1982).

IMPACT OF THE STATUTE

A review of the legislation from the small business viewpoint suggest: the Treasury Department's imposition of the full at-risk provisions of Section 465 is not required by the Statute.

We see three reasons:

1. The intent of Safe Harbor Leasing is to facilitate transfer of tax incidents created by the Accelerated Capital Recovery System (ACRS), and the statute should be construed and interpreted to respect this Congressional intent;

2. The Statute and the Conference Report contain specific limitations to prevent abuse which are meant to and should control the general provisions of section 465; and

3. A contrary interpretation leads to an inequitable result—exclusion of a class of taxpayers, i.e., small and closely-held firms, from the benefits of the law.

The safe harbor lease provisions are found in Section 201, the basic depreciation provision of the Economic Recovery Tax Act of 1981 and in Public Law 97-34 (95 Statutes at large) at pages 214-217.

This section adds a new Section 168 to the Internal Revenue Code, and simply stated, subsection 168(f)(8)A allows deductions and credits arising under the new ACRS to be transferred by lease if the parties so elect.

Subsection 8(B) sets up the following requirements for qualification as purchaser-lessors:

i. they must be corporations other than Subchapter S or personal holding companies defined in IRC section 542(a);

ii. there must be a minimum investment of 10 percent of the property's adjusted basis; and

iii. the lease term must be greater than 90 percent of the property's useful life or 150 percent of the class life.

In subsection (E) at page 47 of the Conference version of the legislation it is explained that: "the term 'minimum investment' means amount the lessor has at-risk with respect to the property (other than financing from the lessee or a related party of the lessee.)"

The significance of the section 542 test is believed to be two-fold. The rationale of imposing an additional personal holding company tax is based on two factors—(1) a small number of individuals sheltering income in a corporation from the personal income tax rates; and (2) type of income that is involved, e.g., passive or non-operating income.

When the leasing provision first surfaced in the Senate, both the bill and the report explicitly applied section 465 (a)(1)(B) and (C) in erecting the definition of a qualified lessor. (See H.J. Res. 266, page 71 and Senate Report 97-144, page 62.)

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[1] The Congressional Joint Tax Committee revenue estimates were $32.8 billion for calendar years 1981-86. See "General Explanation of the Economic Recovery Tax Act of 1981," Joint Tax Committee, Dec. 29, 1981. Table V-4, footnote 5, p. 401.

The final adoption by Congress of the section 542 test—embracing objectionable passive income—is a substantial indication of Congressional preference for a more specific, and therefore less preclusive, standard.

Later in the statute, in section 211(f)(1)(8)(B) (page 61 of the Conference version) the statute specifically applies a specific set of modified at-risk rules to the investment credit. After referring to section 465(b) of the Code, the section goes on to provide that a taxpayer who is at-risk for "an amount equal to 20 percent of the basis . . . of property . . . shall for the purposes of this paragraph be considered at-risk with respect to any amount borrowed in connection with the property . . ." (as long as there is a qualified lender.)

REGULATIONS

In drafting the implementing regulations, particularly as to small business, it is possible to argue that the Treasury Department had several choices short of giving full and immediate effect to the at-risk rules of section 465.

The first alternative would have been to cite specific requirements for lessors under section 201 and for the investment credit under section 221 as specific standards superseding the general provisions of section 465. This construction is consistent with the purpose of the statute—to facilitate the transfer of benefits created by the new ACRS system.

Subsection 8(B), the lessor limitation of section 201, excludes only two types of small businesses—those which have elected to do business as Subchapter S corporations; and those companies which are both closely-held (50 percent owned by 5 or less shareholders) and have the requisite 60 percent of passive income.

This construction is strengthened by the Congressional agreement in Conference regarding the scope of the regulatory authority conferred upon the Treasury Department. The Conference Agreement states: "the conferees intend that the amount and timing of cost recovery allowances in the hands of the lessor would have been the same as they would have been in the hands of the lessee." (Item #22).

This is consistent with the statutory scheme that the lessor should not be able to take advantage of any greater deductions and/or credits than originally were available to the lessee. But this language can be read as intent that the transfer not involve any less benefits either.

A second alternative available to Treasury was to adoption of a clarifying procedure. In fact, such additional efforts were undertaken in the area of strip leases, leases involving possible bankruptcy, and also consolidated returns, as to which portions of the regulations were "reserved."

However, the course Treasury adopted was to promulgate the following rule as a part of the October 20th regulations: "(f) *at-risk requirements.* The amount of investment credit and ACRS deductions that a lessor shall be allowed with respect to the leased property shall be limited to the extent the at-risk rules under the investment tax credit provisions and section 465 apply to the lessee or the lessor."

Later in the regulations, subsection (f)(8)—4(b) explicitly provides that if the seller-lessee is bound by the at-risk rules, then the purchaser-lessor will be equally bound, even if the lessor is a large company and that would presumably be free of the lessor restrictions contained in section 201.

IMPACT ON SMALL BUSINESS

These regulations restricted the participation of small businesses in several ways.

The first impression given to the business community was that participation as lessees for closely-held companies was foreclosed unless they are totally at-risk with respect to the acquisition of the equipment concerned. Subsequent inquiries have not yet resolved the question of whether initial financing is the determinative or the only test.

Because of this, smaller firms were effectively denied the operation of leasing for that period prior to November 13, 1981 when pre-acquired 1981 equipment could qualify for leasing. While it was possible to have small firms refinance on a recourse basis simultaneous with closing on a lease transaction, the necessity for doing so cast an additional cloud over the opportunities for smaller firms.

Then, as to property acquired subsequent to October 20, when the at-risk requirements were clear, another question arose as to a correct procedure where a firm would make a 20 percent down payment and borrow the remainder from a qualified independent lender.

The problem was whether the amounts the lessees received pursuant to the lease would be used by the Treasury Department/IRS to reduce the amounts which were originally at-risk.

There has been continuing uncertainty as to this point, caused by the absence of explanation by Treasury. This lack of certainty has effectively stopped transactions affecting the sale of tax benefits by closely-held companies.

On the other side of the transaction, closely-held corporations have been barred as purchaser-lessors by the requirements of section 465, which extend beyond the 10 percent investment minimum required under the ACRS provisions and the 20 percent required by the investment credit provisions, to impose a burden of total at-risk financing to qualify for the full investment credit and deductions.

It is readily understandable that such a commitment is more difficult and costly for a closely-held lessee than for publicly-held corporations.

However, even for public companies the at-risk as a lessor, of being held to the limitations of a closely-held lessee under the regulations, has constituted a pervasive disincentive for larger corporations to seek the purchase of ACRS benefits from smaller enterprises.

One recent article reported a lease covering assets of $165,000 and noted that Maryland National Leasing Corporation was "getting a tremendous amount of interest from the smaller companies that weren't being solicited by the investment bankers." ("Firm Claims Record as Broker of Tax Breaks through Leases," by Jake Newman, Washington Post, Washington Business, February 8, 1982, page 5). But it is difficult to envision how any closely-held firm could qualify for one of the smaller transactions under the current regulations.

Indeed, the Wall Street Journal Small Business Column of the same day stated: "Small Businesses don't get anywhere near the tax benefits big companies receive from the safe harbor leasing provisions. . . ."

("Leasing Breaks Limited for Small Firms," by Sanford Jacobs, Wall Street Journal, February 8, 1982, p. 29:1).

It can thus be concluded that small businesses have been and remain virtually shut out of both sides of safe harbor leasing transactions.

Such an exclusion would appear to be both discriminatory and inconsistent with the intent of the ACRS and safe harbor leasing provisions.

Thank you for the opportunity to express our views on this section of the Tax Code.

Mr. NOWAK. Well, thank you very much.

I think we can see again the universe out there with different kinds of incentives that would be of some value. The fear that is generally held about this whole leasing provision comes mainly from the media exposure that it has had, and the Occidental Petroleum kind of proposition. You know, we have had some misgivings and also some alternatives being offered, at least at this point in time, as we try to pull together a sensible direction not only for tax policy, but how that affects the whole picture.

Really, one of the prime reasons for this hearing was to try to get some input from the differing small business groups as to where their individuals see it going. You could tell from this morning's hearing that there are some Congressmen even on this committee who do not like leasing. But I think before we disband, which will give us another new start and a new analysis and perhaps a new end, we have got to get some basic consensus drawn as to what will help. I think most generally agree that the interest rate, not only the height of the rate and the variations that we have seen over the past year or so, but the tremendous jumps back and forth, causes that uncertainty. Then, on top of that we have got this leasing coming on, and if you look at the statistics with ACRS alone and see the anticipated revenue loss in 5 years (which is estimated without ACRS), you would have about $122 billion coming in. The last figure on the chart concludes that the corporate tax receipts that you mentioned, Jim, as projected by the Treasury now, we are talking about corporate tax receipts of $122.9 billion in 1986. But when you start to ease out the differentials, such as the ACRS system, and plug that in and then plug the leas-

ing in and then the other smaller reductions that we added in the Tax Code, you end up with a differentiation between $122.9 billion, and you bring that down to $68 billion by 1986.

When you look at all of this in combination with everything else that is out there, one of the reasons, I think, for the interest rate staying there is not this year's deficit, as high as it has been projected. The markets would react, you know, to the inflation portion, the anticipated inflation portion of that interest rate.

If in 1983, 1984, 1985, and 1986 the market community could see that deficit coming down because of what we have done, and of course leasing is a part of it. You would have a different perception, at least in the longer term markets. They would start reacting to that, taking their lumps this year. But unfortunately, you look even at the stock market and all the other things that are happening, as this is projected and we have got the tax cuts. We are going to be looking at individual tax cuts and what portions of the tax cuts we should look at to start to try to find a way to reduce these interest rates. If you look at these different sections, you know, leasing comes to about $27.7 million during the 1981 to 1986 period.

The ACRS by itself eats up $42 billion of that differential between what would have been and what is in existence and projected to the 1986 year, and as some economists have said, you have certainly done a great job in capping your revenue. Now we have increased Defense spending, and those projections are carried out there. Of course, that is where the problem comes in as, in addition to leasing, ACRS, the other provisions, we now add to that indexing and the effect that that is going to have into the 1990's.

So where do we start to reverse this and in the long term, handle the interest rate problem which continues to fluctuate? That's where people are anticipating the rates are going to be in 5, in 6, 7, maybe 12 or 15 years, because of what is structured into the tax law today.

Now, it is one thing to take out leasing entirely because of the perception that is formed. I wonder, though, if the NFIB membership that you are basing your budgests on, have enough information to make that decision today. Based upon what they have read and what they saw, and I am certainly not questioning their conclusion, because if I was out there without seeing the full picture, I guess I would say that, too. But should we see if these changes can be implemented, institute a minimum tax, put a cap on what can be done, and then make the regulatory changes, which I think could be done much earlier? If we needed statutory language, if we could get that through and reduce it and make this available, maybe we would have a limitation on the so-called losses which would help that long-term problem and, at the same time, have something that truly would be available to not only the close corporation, but the partnerships and the individual proprietorships. I think that is what we are going to be facing as we try to pull all of this together and see where everybody's coming from. It's like the problem I am having with inventory accounting and trying to make that indexing available and reduce the pools. If that method was available out there to all the small businesses, that would start to put some equity in, and I am wondering if this could be used in the same fashion, to derive some internal capital formation. I am

not sure of that, and yet it is a real struggle just to explain that inventory thing, and now we get leasing on top of this. I could imagine the small guy who is running a haberdashery shop saying, "What the hell's going on?" And then he reads in the paper, what was it, $400 million is bought up by somebody in one lump sum, and he is sitting there stuck with his own of, little person problems.

But what would you think? What would you respond to that and do you think this situation could be of benefit?

Mr. FITCH. From our perspective, we think that leasing can provide, if made available to small business, a significant cash flow mechanism. We also recognize the fact that leasing is, in fact, a means to give present value to unusable ITC's and depreciation. The problem with refundability is you don't transfer or refund the unused depreciation. It only goes to the investment tax credit.

With ACRS you have significant tax benefits that will pile up for many businesses even with the 15-year carry forward that, without leasing, would make them extremely vulnerable to takeovers. You will, I think, see companies with taxable income going around buying up the small ones strictly for their unused depreciation allowances and investment tax credits. I am not so sure that behavior is in the best interest of the independent entrepreneur or is proper tax policy.

The leasing provisions can be made to work. As you point out, Mr. Chairman, additional knowledge of their usefulness, and, their greater availability at less cost—I understand that a very prominent tax lawyer here in Washington who is closely alined with the leasing provisions is, in fact, putting together a small business leasing package that could be distributed through us to our members or through all small business groups to their membership and significantly reduce their costs and in lay terms explain this leasing provision so the small guys can take advantage of it.

Mr. NOWAK. Ms. Pritchard.

Ms. PRITCHARD. Before Abe comments on all the technicalities, I would like to add that certainly our mandate votes are not able to provide definitive arguments pro or con on the subject. I think the membership, though, is very skeptical as to whether leasing can work. I think there may be a bit of ignorance involved, but I just don't think that they can economically wait. I think they need some sign that the Congress is going to be doing something substantive, and the deficit leasing is a big budget item. Now Abe wrote the question, and he knows a bit more about the technicalities of it.

Mr. SCHNEIER. Certainly your points are well taken. The financial markets are just up in the air right now; when you have long-term rates exceeding short-term rates you know something is going a little crazy out there, and I think what is happening is this leasing provision does apparently provide an alternative method of financing. When you are faced with such high interest rates, you search for any alternative method you can. The question comes down to, whether eliminating leasing, as one part of a package which does restructure the deficits that we are seeing toward the out-years and somehow brings it down. If we could bring interest rates down 3 or 4 points through some restructuring of that deficit

problem we would be helping not only those small businesses who were concerned about purchasing capital equipment, but those inventory intensive firms who also must borrow to finance inventory. So I think the leasing question becomes part of a broader spectrum, as you have alluded to.

Mr. NOWAK. Yes, Jim?

Mr. MCCARTHY. I think the optimum, if you could straighten these laws out so they are usable, if you could make the financing and the handling simpler, still, at the very best, there is going to be 60, 70, 80 percent of the small business community that will be too small to use it. So you are talking about a very important part of the community, the top 20 to 30 percent, but a business with less than $200,000 in assets, no matter how we define this, is not going to get involved. The very small persons are not going to get involved in this type of an arrangement.

Mr. FITCH. Jim, what about the ability for small business lessees to pool. Under the leasing provisions, you can be a lessor if you are a group of corporations. You can be a lessee regardless of your legal status: corporation, partnership, sole proprietor. I don't know of any prohibitions either in the regs or in the statute that would not preclude small businesses from getting together and pooling their unused ITC's and depreciation and, in effect, selling those to a buyer or buyers, which may be a means to effect some cashflow for those folks.

Mr. MCCARTHY. Sometimes it almost looks like we are straining ourselves to rationalize a way of using this technique. Now, there are an awful lot of other techniques that would help these small business people. We have talked about this before, the old new jobs tax credit that pumps money into small businesses who are labor intensive rather than capital intensive. I still think the refundable investment credit, that the very small spectrum, not labor intensive businesses, not heavily capitalized, this is not going to be it; it could be made better. It could be made useful. It is not going to do the job for a large number of the small businesses, the micros and the minis.

Mr. NOWAK. The problems we are facing or will be shortly facing really are going to be, from the one end, to do away with the whole program. I am sure there are some that want to take away the second or third phase of the individual tax cut and save leasing, and there will be some that will be on the other side of those questions. Until we get enough detail, I don't see how we can make those kinds of decisions.

Mr. MCCARTHY. This provision leaves a real bad feeling, and we all debated, and I appeared before this committee, and we debated, and we talked about ACRS at great length, and a lot of us had reservations about it, but we kind of supported it as a last resort, but in all our discussions, Benson and I sat in on a closeted session where we studied ACRS, but we never gave 1 minute's worth of consideration to the leasing provisions. It was hidden in there, and then all of a sudden it has dropped in our lap, and I don't think we have studied it enough.

Mr. NOWAK. Well, that's what we hope to do now, in any event. It is a very poor way to do that, but, of course, we knew that when the tax budget cuts were put together in the fashion they were.

Unfortunately, there is very little flexibility left in this budget, and once you have capped those revenues and increased the other side of those expenditures through the Defense door, there is very little room to move to try to get some substantial effect on that interest rate.

Mr. FITCH. There is a provision in the minimum tax, though, that would add the leasing benefits back in as a preference so that lessor corporations could not zero out using leasing, which is some sort of a recognition on the part of the Treasury Department at least, and Senator Dole for sure to curb the perceived abuse of leasing in the sense that corporations are using it to obviate their tax liabilities.

Mr. NOWAK. I think we are going to see a lot of those alternatives start to surface now. But if you have the opportunity to sit with your boards and receive as broad an input as you could get, maybe you could get back to the committee, with informal testimony. Perhaps you could say to your members: Let's take the premise that we can get these changes in law, we can cap the lessor's benefits, we can put into some sort of minimum tax, and make this totally available to a small issue of leases or a combination and run that through your minds and see if it would have some different appeal to some of your members. I don't know if that is possible.

Yes, sir?

Mr. BAIRD. I can just input something from the panel this morning that I didn't have at the time, is the possible idea of following up on your thought of having more facts on the point. The interest rate concern is real. It seems to me the question is, is leasing inflationary; and if one were to be able to define small business such that some research could rather quickly be done by your Congressional Research Service, then one might be able to better gage whether it is really going to be in small business's interest to reduce interest rates or to effectuate the form in the regulations, such as they can then fully utilize safe harbor leasing.

Mr. NOWAK. Well, we will work on that and see what we can come up with, and hopefully Benson and John can come up with a consensus by this afternoon and get the changes through tomorrow morning. [Laughter.]

But I really appreciate your testimony. I think it gives us a better feeling of where we can move, perhaps we can start to advise some of the other staffs that are around and have input into this. You know, this is a part of a larger question, but I think it is going to be a very critical starting point, and it is going to start to move the whole. If this goes by the boards totally, you are going to see other pieces dissembled very quickly. That indexing is sitting out there, and of course, nobody wants to have their taxes increased, but if you only have revenue enhancement, well, that's not too bad. Indexing, I think, is something that nobody has paid much attention to because you can't see the total impact of that yet. However, I think the markets are reacting rather dramatically today in plugging that into their interest rate calculations as to what they are going to do in the long term, and I think that is going to keep the rate up there for a much longer time than the administration had anticipated. If this happens, this recession that

has at least started will continue to grow and exacerbate the other side of the budget to increase the deficit even more.

I want to thank you again for your testimonies.

Thank you very much.

[Whereupon, at 2:30 p.m., the hearing was adjourned to reconvene subject to call of the Chair.]

APPENDIX

APPENDIX A.—LETTER TO HON. HENRY NOWAK FROM ROBERT D. SHATTUCKS, JR., RE LEASING RULES AND SMALL BUSINESS, FEB. 23, 1982, WITH ATTACHMENTS

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TELEPHONE (205) 252-8847
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SUITE 701
2033 M STREET, N.W.
WASHINGTON, D. C. 20036
TELEPHONE (202) [illegible]

ROBERT D. SHATTUCK, JR.

February 23, 1982

The Honorable Henry Nowak
Chairman
House Small Business Subcommittee
on Tax Access to Equity Capital
United States House of Representatives
Washington, D.C. 20510

Re: Leasing Rules and Small Business

Dear Mr. Nowak:

In connection with your subcommittee hearings on February 25, 1982, concerning small business and the safe harbor leasing provisions, I an enclosing correspondence evidencing the interest of the Chamber of Commerce of Birmingham, Alabama in eliminating the disabilities caused by the application of Sections 46(c)(8) and 465 to closely held corporations as lessors under safe harbor leases.

Very truly yours,

Robert D. Shattuck, Jr.

Robert D. Shattuck, Jr.

RDS,Jr./th

February 19, 1982

Mr. Donald T. Regan
Secretary of Treasury
Treasury Department
15th Street and Pennsylvania Avenue
Washington, D.C. 20220

Re: Denial of Benefits of Leasing Rules
to Small Business

Dear Mr. Regan:

In your February 9, 1982 statement to the House Appropriations Committee, you mentioned the benefits of the new tax leasing provisions to small businesses.

In fact, small businesses have been disabled from effectively utilizing the new leasing rules.

The reason for the disability is that closely held corporations, as lessors under safe harbor leases, are subject to the at risk rules or Sections 46(c)(8) and 465 and, for such reason, are disadvantaged, if not totally unwilling, to be lessors under safe harbor leases. As a consequence, small corporations which would like to sell their tax benefits as lessees under the leasing rules are unable to find buyers for their tax benefits, unless they can locate a big corporation, not subject to the at risk rules, which is willing to be a lessor. As a tax lawyer representing a number of small corporations, I can personally attest to multiple instances of small corporations wanting to sell tax benefits as lessees under the leasing rules, but being unable to do so because they cannot find a big corporation to be the lessor and because smaller, closely held corporations, which are otherwise willing, are advised by their lawyers not to enter into the transaction as lessor by reason of the application of the Sections 46(c)(8) and 465 at risk rules.

The Chamber of Commerce of Birmingham, Alabama is interested in this problem and would like the problem remedied, either by legislation or IRS regulation. I am enclosing some correspondence on this matter which the Treasury Department might review.

Thank you very much for your attention to this letter, and I hope the Treasury Department will do something about the problem to help the small business constituency of the Birmingham Chamber of Commerce and also help small businesses around the country.

Very truly yours,

Robert D. Shattuck, Jr.

RDS,Jr./th

cc: House Appropriations Committee
Senate Finance Committee
House Ways and Means Committee
William S. McKee, Esq.
David E. Dickinson, Esq.
Birmingham Chamber of Commerce
Charles W. Allen

BEST COPY AVAILABLE

ROBERT D. SHATTUCK, JR.
1710 First National-Southern Natural Building
Birmingham, Alabama 35203
(205) 252-8847

November 19, 1981

Birmingham Chamber of Commerce
2027 1st Avenue, North
Birmingham, Alabama 35203

Re: Small corporations unfairly excluded
from benefits under new tax leasing rules

Gentlemen:

In the three months since the August 13, 1981 enactment of the new tax leasing rules under the Economic Recovery Tax Act of 1981:

-Ford Motor Company, which had bought $300 million of machinery, reduced its cost by selling the tax benefits of the machinery to IBM for $78 million cash. Done under the new tax leasing rules.

-New York City has sold to Metromedia, Inc, the tax benefits on $102 million of public transportation vehicles for $15.2 million cash. Done under the new tax leasing rules.

-Chrysler Corporation wanted to sell tax benefits under the new leasing rules for $30 million. This had to be done by November 13, 1981. IRS issued regulations on October 20, 1981 and Chrysler's planned buyer of the tax benefits backed off. Chrysler complained and IRS changed the regulations on November 10, 1981. Chrysler sold the tax benefits to the buyer for $30 million prior to its November 13, 1981 deadline.

-Chicago, Milwawkee, St. Paul and Pacific Railroad Co. has sold the tax benefits on $23 million of track rehabilitation work for $15 million cash, reducing the railroad's cost of the work by more than one half.

A pillar of President Reagan's Economic Recovery Tax Act of 1981 was the business incentives to be provided by greatly liberalized tax depreciation deductions. Because

many companies could not effectively utilize the increased tax benefits, the new tax leasing rules were included in the tax law to allow these corporations to receive all or some of the intended benefits by selling the tax deductions and credits to other corporations for cash.

Hypothetical Troubled Small Co., which has heard about the new leasing rules and sale of tax benefits, wants to acquire $500,000 of equipment, but it can finance only $400,000 of the cost. Troubled Small Co. contacts Prosperous Small Co., which is willing to pay $100,000 cash to Troubled Small Co., in exchange for the tax benefits on the $500,000 of equipment. The additional $100,000 cash will be just enough to allow Troubled Small Co. to buy the equipment.

Troubled Small Co. and Prosperous Small Co. call in their lawyers and accountants to do the transaction. The lawyers and accountants study the new tax leasing rules, confer among themselves, and advise Troubled Small Co. and Prosperous Small Co. that they cannot do the transaction. Thereafter, Troubled Small Co. goes bankrupt and its seventeen employees are out of work.

Ford, IBM, Chrysler and other large corporations are jumping all over the new tax leasing rules, which E.F. Hutton calls "definitely the biggest show on Wall Street". But tens of thousands of small corporations have been unfairly excluded from participation in these new transactions. The IRS quickly changes its regulations at the behest of Chrysler, while small companies are left out in the cold.

This discrimination which prevents small corporations from using the new tax leasing rules should be given attention by the Chamber of Commerce, with a view to publicizing the situation and undertaking a lobbying effort to remedy the same.

Very truly yours,

Robert D. Shattuck, Jr.

Robert D. Shattuck, Jr.

RDS,Jr./th

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Birmingham
America's Magic City
Community Affairs
Birmingham Area Chamber of Commerce

December 7, 1981

Robert D. Shattuck, Jr.
1710 First National-
Southern Natural Building
Birmingham, Alabama 35203

Dear Mr. Shattuck:

Thank you for your letter concerning the new leasing rules, under the Economic Tax Act of 1981. Mr. Shattuck, your letter pointed out a problem we were unfamilar with, so we asked our Small Business Committee to investigate. The Committee identified Section 168, part (F) (8) (i) (ii) and (B) (i) (I) covering special rules for leasing as the part of the law your letter spoke of.

I have enclosed a copy of a letter submitted to me by Charles Allen, Chairman Small Business Committee, stating the Committees thoughts on this matter. Apparently this means a business can elect to be covered under Section 1371 (B), or not to be covered.

We hope that this answers your questions. If you would like to discuss this in more detail please give me a call at 323-5461.

Respectfully yours,

Larry Bateman

Larry Bateman

Commerce Center • 2027 1st Ave., North • P. O. Box 10127 • Birmingham, Alabama 35202 • 205/323-5461

SCHOLL, ALLEN AND CALDWELL
ATTORNEYS AT LAW
(205) 323-1888

LOUIS W. SCHOLL
CHARLES W. ALLEN
CHARLES E. CALDWELL

SUITE 930
WOODWARD BLDG
BIRMINGHAM, AL 35203

December 1, 1981

Mr. Larry Bateman
Birmingham Chamber of Commerce
2027-1st Avenue North
Birmingham, Alabama 35203

RE: Reply to Robert D. Shattuck, Jr.'s letter on new tax leasing rules

Dear Larry:

Under the Economic Recovery Tax Act of 1981, at Section 168, part (F) (8) (A) (i) (ii) and (B) (i) (I), covering special rules for leases, it is stated:

"(8) Special rule for leases.

"(A) In general.- In the case of an agreement with respect to qualified leased property, if all of the parties to the agreement characterize such agreement as a lease and elect to have the provisions of this paragraph apply with respect to such agreement, and if the requirements of subparagraph (B) are met, then, for purposes of this subtitle -

"(i) such agreement shall be treated as a lease entered into by the parties (and any party which is a corporation described in subparagraph carrying on a trade or business), and

"(ii) the lessor shall be treated as the owner of the property and the lessee shall be treated as the lessee of the property.

"(B) Certain requirements must be met.- The requirements of this subparagraph are met if-

"(i) the lessor is-

"(I) a corporation (other than an electing small business corporation (within the meaning of section 1371 (b))...."

Mr. Larry Bateman

Page 2

1371(b) is one of the basic sections dealing with a Sub Chapter S Corporation.

My understanding for the passage of this section was to spur the economy by giving tax relief to corporations that would most affect the economy by giving them more of a tax write-off to reduce the tax bill and in return free capital to be reinvested to stimulate economic recovery.

The qualifier in (B) (i) (I) pertaining to Sub Chapter S Corporations is not unreasonable for the following grounds:

1. An election under 1371(b) treats a small corporation as a partnership for tax purposes,
2. The partners in turn are taxed on their distributive share of the profits from the corporation as ordinary income,
3. The tax treatment means they are taxed as individuals not corporations,
4. Consequently, the intended tax relief is for corporations who have not made a election and who do not come under 1371 (b) as the law is intended to help corporations, not individuals, reinvest,
5. The apparent rational was that a non 1371(b) corporation would most likely be in a better position and need to reinvest than a 1371(b) corporation that for tax purposes is treated as a partnership or group of individuals.

I hope this answers the above-mentioned letter, but, if you need a further explanation, let me know.

Respectfully,

CHARLES W. ALLEN

CWA/ps

December 10, 1981

Mr. Larry Bateman
Birmingham Area Chamber of Commerce
2027 1st Avenue, North
P.O. Box 10127
Birmingham, Alabama 35202

RE: New Tax Leasing Rules

Dear Mr. Bateman:

Thank you very much for your December 7, 1981 letter and Mr. Charles W. Allen's letter, in response to my November 19, 1981 letter calling attention to an unfair discrimination against small corporations under the new tax leasing rules.

Because my November 19, 1981 letter was somewhat vague and indefinite about the problem I was trying to call attention to, Mr. Allen was justified in focusing on the exclusion of Subchapter S corporations from qualifying as lessors (purchasers of tax benefits) under the new tax leasing rules. My November 19, 1981 letter was vague and indefinite because the discrimination in question is subtle, but all the more serious, since it is hidden from view and not immediately apparent to those parties which are adversely affected until they actually try to do a transaction under the new rules. The problem which I was calling attention to is not the exclusion of Subchapter S corporations from qualifying as lessors under the new rules (as Mr. Allen thought), but rather is a much farther reaching discrimination which is frustrating and will continue to frustrate small corporations which try to utilize the new tax leasing rules to achieve their intended benefical economic effect. The Internal Revenue Service knows well the nature of this discrimination, but it does not appear that the Internal Revenue Service will do anything about it unless and until small corporations complain vociferously enough about the discrimination.

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Having made the foregoing introductory statement, I will now proceed to indicate more clearly what the problem is I am trying to call attention to.

In 1976, Congress enacted the so called "at risk" rules. The "at risk" rules were designed to counteract perceived tax shelter abuses by individuals through the use of non-recourse obligations for which the individual was not personally liable. (Because, as Mr. Allen points out, Subchapter S corporations are taxed in a similar fashion as if a partnership of individuals, the "at risk" rules were also made applicable to Subchapter S corporations in 1976.)

In 1978, the "at risk" rules were extended to apply to all closely held corporations. A closely held corporation, for this purpose, is any corporation which is more than 50% owned by 5 or fewer persons who are unrelated to one another. The exact rationale of why the "at risk" rules were extended to all closely held corporations is not entirely clear. In any event, every corporation in the United States controlled by one family or a small group of families, whether it has $100,000 of revenues or $100,000,000 of revenues, comes within the definition of a closely held corporation for purposes of being subject to the "at risk" rules.

In August 1981, the new tax leasing rules were enacted as part of the Economic Recovery Tax Act of 1981. My November 19, 1981 letter explained that the purpose of the new tax leasing rules was to allow corporations which could not utilize their increased tax depreciation deductions and their investment tax credit to sell the tax benefits to other corporations for cash and thereby obtain all or a part of the intended benefits to promote the nation's economic recovery. As indicated by my November 19, 1981, large corporations have already done billions of dollars of transactions under these new leasing rules.

What, then, is the problem for small corporations? The problems is not whether a small or closely held corporation can or cannot sell tax benefits under the new tax

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leasing rules (for it is clear that it can do so), but rather the problem is to whom the tax benfits can be sold and, in particular, that small or closely held corporations are effectively excluded as purchasers of tax benefits. This problem for small corporations grows out of the compromise, and give and take, of enacting legislation, under the press of time, in which the consequences of actions taken at the time may not be fully appreciated. Allow me to give some of the history.

Under the House version of the Economic Recovery Tax Act, closely held corporations would have been completely excluded as purchasers of tax benefits under the new leasing rules. In the conference bill which was ultimately enacted into law, the total exclusion of closely held corporations as purchasers of tax benefits under the new leasing rules was eliminated, but the law included a vague provision to the effect that the IRS would "prescribe such regulations as may be necessary to carry out the purposes of this paragraph [the new leasing rules], including (but not limited to) regulations consistent with such purposes which limit the aggregate amount of (and timing of) deductions and credits in respect of qualified leased property to the aggregate amount (and the timing) allowable without regard to this paragraph."

Some informed tax practitioners interpreted the vague statutory provision as meaning that, although closely held corporations could qualify as purchasers of tax benefits under the new leasing rules, the previously existing "at risk" rules would continue to apply to closely held corporations as purchasers of tax benefits under the new leasing rules. Without going into a technical explanation, the consequence of this would be that closely held corporations would be greatly disadvantaged in entering into transactions under the new leasing rules as purchasers of tax benefits, as compared to the situation for other corporations, if not make it entirely impossible for closely held corporations to enter into transactions under the new leasing rules as the purchasers of tax benefits.

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Apparently the Treasury Department felt that this consequence was a little bit extreme and unfair, because, on October 5, 1981, Assistant Treasury Secretary John Chapoton gave a speech in New York in which he stated that the "at risk" rules would not be applied to closely held corporations which entered into transactions under the new leasing rules as purchasers of tax benefits.

Thereafter, the Treasury Department decided that this could not be done under the new tax leasing rules, as written, because the Internal Revenue Service, on October 20, 1981, issued temporary regulations under the new leasing rules which stated exactly the opposite, to wit, that closely held corporations as purchasers of tax benefits under the new leasing rules would be subject to the "at risk" rules. The issuance of the temporary regulations was accompanied by a Treasury Department statement to the effect that the Treasury Department could not ignore the statutory enactment in question, but that remedial legislation might be sought.

How, then, does the matter stand? Small and closely held corporations can clearly sell tax benefits under the new tax leasing rules. The question is whom can they sell the tax benefits to. The big or publicly traded corporations have been and are going to continue to be doing transactions under the new leasing rules with other big or publicly traded corporations. A small or closely held corporation which wants to sell tax benefits is going to be uncomfortable or unable to do these transactions with a big or publicly traded corporation and, in many cases, will only be able to find another small or closely held corporation to do the transaction with. However, as it presently stands, a small or closely held corporation will be extremely disadvantaged or else find it impossible to act as a purchaser of tax benefits under the new leasing rules because of the application of the "at risk" rules. The end result is that the new leasing rules simply are not going to be utilized on the small corporation level the way that they were intended to be utilized and the way they are in fact being utilized on the big corporation level. This is the problem my November 19, 1981 letter was about.

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In summary, I believe that there is an unfair and inappropriate discrimination against small or closely held corporations finding other small or closely held corporations to be purchasers of tax benefits and thereby effectively utilizing the new leasing rules. I further believe that this discrimination problem is hardly or not at all known about in the small corporation community in the Birmingham area and elsewhere. I believe that the nature of this problem should be made known to those small corporations who are adversely affected. Finally I believe that, if and when this discrimination problem is known and understood by the small corporation community, the small corporation community will want to try to take action to have the discrimination problem remedied immediately.

I hope this letter has adequately explained what my November 19, 1981 letter was all about.

Very truly yours,

Robert D. Shattuck, Jr.

RDS,Jr./th

cc: Charles W. Allen, Esq.

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APPENDIX B.—LETTER TO HON. HENRY NOWAK FROM HILTON DAVIS, VICE PRESIDENT, LEGISLATIVE ACTION, CHAMBER OF COMMERCE OF THE UNITED STATES, BE BEARINGS ON SAFE HARBOR LEASING PROVISIONS OF THE ECONOMIC RECOVERY TAX ACT OF 1981; WITH ATTACHMENTS, MARCH 3, 1982

ADVANCING VOLUNTARY LEADERSHIP IN A CHANGING WORLD

Chamber of Commerce of the United States

HILTON DAVIS, VICE PRESIDENT
LEGISLATIVE ACTION

202 - 659-6140

1615 H STREET, N.W.
WASHINGTON, D.C. 20062

March 3, 1982

The Honorable Henry Nowak, Chairman
Subcommittee on Tax, Access to Equity
Capital and Business Opportunities
Committee on Small Business
House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

This letter is in regard to your recent hearings on the Safe Harbor Leasing Provisions of the Economic Recovery Tax Act of 1981 (ERTA).

On February 18, 1982, the U.S. Chamber's Board of Directors approved the attached legislative proposals which constitute our Small Business Tax Program. We believe that this program provides a comprehensive approach to tax changes of benefit to small business.

Item #10 recommends that the safe harbor leasing provisions contained in ERTA be broadened to allow closely held businesses to participate as lessors without the application of Section 465 "at-risk" rules. Section 465 restricts the amount of depreciation deductions and investment tax credit which a taxpayer may claim to the amount the taxpayer has "at risk" in the form of equity and recourse financing.

Since safe harbor leases generally depend on nonrecourse financing, Section 465 not only effectively restricts the availability of the safe harbor leasing provisions for closely held small businesses (companies in which 50 percent of the value of outstanding stock is owned directly or indirectly by not more than 5 individuals), but also discriminates against small businesses by not allowing them to make use of the leasing provisions which are available to larger corporations. This inequity should be corrected.

One of the major problems facing smaller firms today is the cost of debt financing. Leasing is an attractive way to finance needed capital expansion. Although leasing is not now being extensively used by small business, we expect this will change as more brokers begin to focus on this rather large potential market. According to the 1976 Statistics of Income, companies with less than $100,000 in total assets comprise 48.7% of all corporations with net income, while this same category constitutes over 71% of all corporations without net income. As more leasing transactions are accomplished, the transaction costs will decrease and the ability to "pool" potential lessors and lessees will increase. Many of these small companies with losses will find leasing to be a viable alternative to more traditional financing methods.

Safe harbor leasing is an important part of the Accelerated Cost Recovery System. It helps assure that the entire economy will be stimulated without encouraging unsound investments made strictly as tax shelters, and it substantially reduces the complexity and uncertainty embodied under the old leasing rules. For these reasons we support changes to allow full participation by the small business community.

We will appreciate your considering our views and request that this letter be made a part of the hearings record.

Cordially,

Hilton Davis
Vice President
Legislative Action

cc: Subcommittee Members

Attachment

ATTACHMENT

Small Business Tax Program

1. Corporate Rates
   Reduce corporate rates on the first $500,000 of taxable income.

2. Capital Gains
   The effective rate of tax and capital gains should be reduced in order to increase the availability of investment capital.

3. Investment Tax Credit For Used Equipment
   The annual limitation for investment in used qualifying property for purposes of the investment tax credit should be increased to at least $250,000. (Prior Board Statement set amount at $200,000)

4. LIFO Recapture
   Repeal the LIFO Recapture Provision (Section 403(b) of the Windfall Profit Tax Act). (The Tax Committee approved this position October 1, 1981)

5. Inventory Simplification
   Further simplify the tax accounting for inventories by allowing a single pool of goods for small business and the use of exogenous indexes. (New)

6. Minimum Accumulated Earnings
   The minimum credit for earnings which may accumulated before any accumulated earnings tax would apply should be increased to at least $500,000. (Same as prior Board Statement.)

7. Subchapter S Corporations
   Revise the Subchapter S provisions to make their use more widely available to small business, by, among other changes, increasing the maximum number of Subchapter S shareholders and expanding the categories of eligible shareholders. (Same as prior Board Statement)

8. Closely Held Business Rollover
   Permit the Owners of a closely held business to defer tax on the sale of the equity of the business if the proceeds are reinvested within a specific time in other small business investments.

9. Independent Contractors
   A safe harbor provision should apply to individuals historically treated as independent contractors and a withholding tax should not be required. (Position adopted by the Board June 21, 1979)

Adopted by the Board of Directors, Chamber of Commerce of the U.S.
February 18, 1982

10. Leasing
The safe harbor leasing provisions contained in the Economic Recovery Tax Act of 1981 should be broadened to allow closely held businesses to participate as lessors without the application of the Section 465 at-risk rules. (New)

11. Debt-Equity
The debt-equity rules issued pursuant to Section 385 should be written to enable smaller firms to easily comply with the law. (New)

12. DISC
Tax incentives such as DISC should be preserved and enhanced in order to foster small business exports. (New)

Appendix C.—Prepared Statement of Jonathon O. Moore, President, Air U.S.

Statement of Jonathon O. Moore

Before the Subcommittee on Tax,
Access to Capital and Business
Opportunities of the House Committee
on Small Business

Good morning. My name is Jonathon Moore, and I am president of Air U.S., a small commuter airline serving communities in Colorado and Wyoming. Air U.S. currently operates five commuter planes, one of which was acquired last year in a transaction involving a safe-harbor lease. We hope to add one additional plane this April and another by early fall. Whether or not we are able to continue our expansion will, to a large extent, depend on whether safe harbor leasing is available.

Introduction

I commend the Committee for its decision to review the impact of the safe-harbor leasing provisions. A key factor that Congress must analyze is the value of these provisions to businesses which do not make the Fortune 500 ranking. As other witnesses have indicated to you, the recentness of the legislation, and the fact that most information to date relates to the retroactive effect of the legislation may give a distorted and understated view of the significance of safe-harbor leasing to small business. In spite of this, however, the Treasury has submitted data which reflects the very significant use of safe harbor leasing by small business. I believe it is clear that small business

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is using safe harbor leasing, and that the proportion of safe harbor leases by small business will continue to grow as the transactions become standardized.

Other witnesses have testified today regarding some of the impediments to the use of safe harbor leasing by small business, for example, the recapture rules in the case of lessee insolvency. I am sure you will find their testimony useful and interesting. However, in my testimony today, I would like to focus my remarks on sharing with you the enthusiasm we feel for safe harbor leasing, the future plans we have involving safe harbor leasing, and what is the biggest impediment - a nonstatutory impediment - facing us today.

Who Benefits from Safe Harbor Leasing?

Air U.S. is one small business that has and will benefit from the Economic Recovery Tax Act's safe harbor leasing provisions. Air U.S. has planned to purchase at least two new airplanes during the remainder of 1982. These planes would be used to initiate and improve service to communities in Wyoming, Colorado, and (hopefully) other Western States. Not only will this expansion improve service to Essential Air Service locations, it will also result in the creation of 250 permanent, high quality jobs. With financial markets in disarray and the economy in a recessionary state,

this expansion would be impossible without the benefits of safe-harbor leasing.

The ability of Air U.S., and small businesses in general, to transfer tax benefits is an essential method of financing in the current economic climate. Indeed, because financing is, even in the best of times, more problematical for small businesses than for large long-established concerns, safe harbor leasing has an especially important role for the small corporation and the small entrepreneur. In addition, the commuter airline industry makes significant use of the Federal Aviation Administration's Aircraft Purchase Loan Guarantee Program, guarantees which could not be used in conjunction with traditional sale-leaseback techniques. But FAA loan guarantees are available for safe harbor leasing transactions, and they are being used.

The Threat of Repeal

As you can see, safe harbor leasing is of tremendous value to small commuter air carriers like Air U.S. Nonetheless, a shadow has been cast over safe harbor leasing recently, and this shadow threatens to undermine our plans for expansion and improvement of service. Senator Dole has announced that he will seek the repeal of safe harbor leasing retroactively to February 19, 1982. It is unlikely that Congress will actually deal with this proposal until

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May, but in the meantime his comments have removed the certainty from transactions that demand certainty. Distressingly, Senator Dole's announcement amounts to a change in our tax law by individual fiat, since the in terrorem effect of the announcement has caused a general cessation of lease activity. It will, as you might expect, be difficult to move ahead with our airplane acquisition program because of this announcement. I urge this Committee to do whatever it can to preserve and improve safe harbor leasing. The first step is, I suggest, to call for the prompt retraction, or at least clarification, of Senator Dole's proposal. If Senator Dole's goal is really some reasonable limitation of safe harbor leasing, a specific proposal should be made as soon as possible, so that the current economically harmful uncertainty and general freeze on leasing may end.

By way of conclusion, I would like to note that the "safe harbor" leasing provisions were the bright spot in the Economic Recovery Tax Act for the badly depressed commuter airline industry. After decades of regulation, airline deregulation has resulted in an extraordinary and volatile situation in the airline industry. It is a condition which demands the highest efficiency possible. Safe-harbor leasing meets this demand. It continues the progress of deregulation by allowing small airlines, such as Air U.S., to expand, adapt, and improve their efficiency. I strongly urge you to help continue its benefits.

Appendix D.—Prepared Statement of Norman R. Sherlock, President, Chief Executive Officer, American Bus Association

STATEMENT OF

NORMAN R. SHERLOCK

PRESIDENT AND CHIEF EXECUTIVE OFFICER

AMERICAN BUS ASSOCIATION

BEFORE THE

SUBCOMMITTEE ON

TAX, ACCESS TO EQUITY CAPITAL

AND BUSINESS OPPORTUNITIES

COMMITTEE ON SMALL BUSINESS

U. S. HOUSE OF REPRESENTATIVES

ON

SAFE HARBOR LEASING

FEBRUARY 25, 1982

Mr. Chairman and Members of the Subcommittee:

My name is Norman R. Sherlock. I am President and Chief Executive Officer of the American Bus Association (ABA), the national trade association for the intercity bus industry. The ABA represents private bus operators that provide regular scheduled service, local commuting, tours and charters, as well as special operations.

The intercity bus industry is comprised of approximately 1,400 individual bus companies which carry passengers between communities in this country. Although many people visualize the industry as being the two large nationally organized carriers, Greyhound Lines and Trailways, there are approximately 1,200 other companies engaged in intercity bus service. In fact, of the 378 million passengers carried last year, about 70 percent were carried by the other smaller regional or local bus operators.

In addition, among our members, there are about 1,450 entities engaged in travel and tourism activities throughout the country -- theme parks, attractions, restaurants, hotels and motels. The preponderence of those who are engaged in private business are small business enterprises.

In fashioning small busines and tax policy, it is important to understand the nature of this industry and the role that it plays in transportation, both now and in the future. First, the bus is the most energy efficient mode of transportation today. It requires, for example, less than one-third of the fuel needed to transport an equivalent number of people otherwise carried by either train or car. Consequently, its expanded use will save energy and substantially reduce fuel consumed in passenger transportation. Second, the intercity bus industry serves more than 1,500 communities in this country over 280,000 miles of routes. Over 1,400 of these communities are served directly only by the intercity bus industry. As automobile use necessarily declines in the future, it will be the intercity bus operator who will provide mobility to our rural areas and small towns, as well as between urban centers. Third, the bus industry carries more passengers than any other form of public intercity transportation. The total of 378 million passengers carried last year is more than the airlines and Amtrak combined. Fourth, the intercity bus industry has emerged as a very important factor in maintaining the economic welfare of the travel and tourism industry, an activity that accounts for $8.9 billion in our national economy. Tourism is the first, second, or third largest industry in at least 40 states.

The ability of the intercity bus industry to fulfill its potential as a fuel-saving alternative to individual automobile

use and to rail passenger service will be largely dependent upon the way that national transportation, energy, and tax policies are crafted. While it is essential that the role of this industry be expanded, the capital necessary to do so must be provided to the intercity bus companies in order to meet this demand. Even Greyhound and Trailways, with their access to national capital markets, will have some problem in obtaining all the capital they need to expand their service to meet the developing needs of the public. The small carriers will have a still more difficult time.

When we appeared before the House Small Business Committee last year, Congress was debating tax changes to improve business productivity. You, Mr. Chairman, and others worked on a comprehensive small business tax package focused on the needs of small business. I congratulate you on the legislation resulting from your hard work and dedication, the Economic Recovery Tax Act of 1981.

The safe harbor leasing provisions of this tax act are currently under severe attack. The Department of the Treasury reports that the discussion to repeal or limit leasing provisions, particularly Senator Dole's February 19, 1982, comments, has disrupted many plans for safe harbor leasing transactions. When,

after only one year's experience with these provisions, one can see the potential benefits for small businessmen, the American Bus Association would not want them to be repealed or limited. The ABA supports the safe harbor leasing provisions of the 1981 tax act and believes that they have great potential for the small businessmen who own and operate intercity buses. I would like to emphasize certain general points about leasing and its application to the intercity bus industry.

Typically, small businesses finance their operations from current earnings or from borrowing, and tend to rely on equity financing to a lesser extent. The ability of smaller companies to sell their tax benefits can become an important source of financing. This is important to the intercity bus industry, since it has experienced a decline as a regular route carrier. In response to current regulation of the intercity bus industry which has permitted intermodal competition from air, rail, and automobile travel to overwhelm the regular route intercity bus services, the industry is looking to bus regulatory reform legislation, HR 3663, as passed in the House of Representatives on November 19, 1981, and now pending in the Senate Commerce, Science and Transportation Committee, to overcome this problem. The industry also looks to favorable tax policy.

In essence, the safe harbor leasing rules provide incentives for the intercity bus companies, including those which have

not yet produced large profits, to invest in new equipment. Leasing provisions would therefore allow spending that may not occur otherwise. The cost of a new intercity bus today is approximately $160,000; the cost of a used bus is in the $60,000 range. The capital investment of an intercity bus owner in new equipment, therefore, is considerable. Furthermore, companies which cannot fully utilize the tax benefits associated with new investments in plant and equipment can be helped by leasing provisions. Leasing allows investments to be equally profitable for companies in different tax situations.

Because safe harbor leasing provisions are relatively new, a complete and meaningful assessment of safe harbor leasing as a means of encouraging small business capital investment cannot yet be made. Many small businessmen are unfamiliar with the leasing provisions and how they can be applied to assist their own company in their own particular set of circumstances. Likewise, the leasing industry, namely investment bankers, attorneys, and accountants, must become more familiar with the rules and the necessary leasing documents in order to increase the availability of leasing benefits to small businesses.

Nonetheless, it appears that many smaller companies have been able to use leasing rules effectively in the short time since they have been available. According to the Department

of the Treasury's study of 16,500 information returns filed with the Internal Revenue Service through the end of February of this year, close to 88 percent of the safe harbor leasing transactions completed involved property worth less than $10,000. This suggests that small businesses are taking advantage of the leasing provisions, despite the fact that many are probably not totally familiar with the details of the provisions and how they are advantageous to the small businessman. Other problems such as the legal fees associated with drafting the necessary documents, some small companies' insufficient access to investment banking firms positioned to broker the leasing transactions, initial confusion surrounding the statute and its regulations, and the time lag needed for many businesses to develop confidence in safe harbor leasing as an additional or alternative means of financing capital investment are additional hurdles that must be overcome by the small businessman in order for him to take full advantage of these provisions.

An example of how the intercity bus industry has employed the safe harbor leasing provisions is that of Empire Trailways, Inc., based in Rochester, New York. This bus company has had a very good experience with safe harbor leasing. In fact, Ernst and Whinney, the accounting firm involved, in cooperation with the Rochester Chamber of Commerce, presented a seminar on "The Tax Benefits of Leasing Under the Economic

Recovery Tax Act of 1981" on January 27, 1982, and used Empire Trailways as a successful example of how these provisions could be employed by small business. I am submitting for the record a copy of the written material prepared in connection with this summary for your use in evaluating the effectiveness of the program.

Mr. Andrew Greenstein, President of Empire Trailways, explained in a letter to me that Empire Trailways purchased five motor coaches during 1981 for an aggregate purchase price of approximately $650,000. The sale of the investment tax credits and the depreciation for these vehicles netted $116,000 for the company. According to Mr. Greenstein, it was obvious to the company at the start of 1981 that it would not possibly be able to use investment tax credit carry forwards that it had available to it. Secondly, the company knew that an additional three or four buses would be purchased in 1981 and that capital improvements to a new garage would also provide substantial additional tax credits. Empire Trailways retained title to the buses. While safe harbor leasing has been criticized as being complicated, Empire Trailways found the leasing document to be relatively simple to formulate and felt that the transaction went through rather smoothly.

In spite of present federal budget deficits, this provision is sound small business policy. While some look to the repeal

or limitation of safe harbor leasing provisions as one way of reducing these deficits, the American Bus Association feels this is a short-term attitude that ignores the long-range positive effects of the leasing provisions on the economy. Already, in the current economic environment of high interest rates, inflation, and unavailability of credit which faces every business and operation, the small business owner is feeling these effects most acutely. As the economy improves and as the small businessman becomes more familiar with and has more confidence in the safe harbor leasing provisions, more and more small companies will take advantage of them.

On behalf of the American Bus Association, I commend the Subcommittee for addressing the issue of safe harbor leasing and for giving us this opportunity to be heard.

APPENDIX E.—"TAX BENEFITS OF LEASING UNDER THE ECONOMIC RECOVERY TAX ACT OF 1981." SEMINAR ROCHESTER AREA CHAMBER OF COMMERCE JANUARY 27, 1982

E&W

ERNST & WHINNEY

IN COOPERATION WITH

ROCHESTER AREA CHAMBER OF COMMERCE

PRESENTS A SEMINAR ON

THE TAX BENEFITS OF LEASING

UNDER THE

ECONOMIC RECOVERY TAX ACT OF 1981

January 27, 1982
55 St. Paul Street
Rochester, New York

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AGENDA

Registration Coffee & Donuts	
Introduction	Al Murrer Chairman of the Board Gleason Works and Rochester Area Chamber of Commerce
Overview and General Comments	Paul Faux Managing Partner Ernst & Whinney
Explanation of ERTA Rules with Example	Howard Buchan Manager, Tax Services Ernst & Whinney
The Role and Perspective of the Banker	Dave Whitaker President, SNY Leasing Division of Security Trust Company
The Leasing Instrument	Steve Sundell Mousaw, Vigdor, Reeves, Heilbronner & Kroll
Coffee Break Economics and Accounting Treatment	
The Use of Present Value Analysis in Determining Price	Mike Lohwater Manager, Management Consulting Services Ernst & Whinney
Financial Reporting Considerations	John A. Seifarth Partner Ernst & Whinney
Panel Discussion Seller	Andy Greenstein President Empire Trailways, Inc.
Buyer	Henry Epstein President Spectrum Office Products
Adjournment	

THE USE OF PRESENT VALUE ANALYSIS

IN DETERMINING PRICE

MICHAEL A. LOHWATER
MANAGER, MANAGEMENT CONSULTING SERVICES
ERNST & WHINNEY

I. THE TIME VALUE OF MONEY IS THE KEY TO PRESENT VALUE

A. Exists because money has profitable uses

B. Measured by rate of return on most profitable alternative use

II. INTEREST RATES ARE APPROXIMATIONS OF TIME VALUE

A. Borrower and lender agree on rate for each circumstance

B. Rates are higher when risks are greater

III. COMPARING ALTERNATIVE USES OF MONEY

A. Select a reference point in time for comparison

B. Bring all amounts to the reference point

C. Alternatives are comparable at the reference point

IV. PRESENT VALUE COMPUTATIONS

A. Computations put future tax benefits in terms of equivalent current benefits

B. Usefulness of computations is dependent on selection of appropriate interest rate

V. CHOICE OF INTEREST RATE

A. Management decision - should use rate of return of best investment opportunity

1. Return on owners' equity?
2. Rate on borrowed debt?
3. Rate on government securities?
4. An average rate?

VI. PRESENT VALUE FACTORS

A. Term of the lease and note

B. Discount rate

C. Future taxable income and tax rates

VII. CASH FLOW ANALYSIS--BUYER OF TAX CREDITS

A. Down payment

B. Tax benefits relating to asset

- o ITC
- o ACRS deductions

C. Tax penalties (net)

- o Rental income
- o Interest deductions from note

D. Purchase option

- o Cash inflow

E. EXAMPLE ASSUMPTIONS

ASSET PURCHASED	$600,000
CASH PAYMENT	$125,000
RECOVERY PERIOD	5 YEARS
LEASE TERM	7 YEARS
TAX RATE	50%
DISCOUNT RATE	20%
NOTE PRINCIPAL	$475,000
NOTE INTEREST RATE	18%
MONTHLY RENTAL PAYMENTS	$10,000
PURCHASE OPTION	$75,000

EXAMPLE

SCHEDULE A
DOWN PAYMENT

LINE	YEAR	(IN THOUSANDS) 0	1	2	3	4	5	TOTAL
1	DOWN PAYMENT	125	-0-	-0-	-0-	-0-	-0-	125
2	DISCOUNT RATE (20%)	1.000						
3	PRESENT VALUE	125						125

EXAMPLE

SCHEDULE B
TAX BENEFITS RELATING TO ASSET

LINE	YEAR	(IN THOUSANDS) 0	1	2	3	4	5	TOTAL
1	INVESTMENT CREDIT	60	-0-	-0-	-0-	-0-	-0-	60
2	ACRS DEDUCTIONS	90	132	126	126	126	-0-	600
3	TAX BENEFIT AT 50% RATE	45	66	63	63	63	-0-	300
4	TOTAL TAX BENEFIT	105	66	63	63	63	-0-	360
5	DISCOUNT RATE (20%)	1.000	.833	.694	.579	.482	.402	
6	PRESENT VALUE	105	55	44	36	30	-0-	270

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EXAMPLE

SCHEDULE C
TAX PENALTIES (NET)

LINE	YEAR	(IN THOUSANDS) 1	2	3	4	5	6	7	TOTAL
1	RENTAL INCOME	120	120	120	120	120	120	120	840
2	INTEREST DEDUCTION	82	76	68	56	44	28	12	366
3	TAXABLE INCOME	38	44	52	64	76	92	108	474
4	TAX AT 50% RATE	19	22	26	32	38	46	54	237
5	DISCOUNT RATE (20%)	.833	.694	.579	.482	.402	.335	.279	
6	PRESENT VALUE	16	15	15	15	15	15	15	106

EXAMPLE

SCHEDULE D
PURCHASE OPTION

LINE	YEAR	(IN THOUSANDS) 1	2	3	4	5	6	7	TOTAL
1	CASH PAYMENT	-0-	-0-	-0-	-0-	-0-	-0-	75	75
2	DISCOUNT RATE (20%)							.279	
3	PRESENT VALUE							21	21

EXAMPLE

CASH FLOW ANALYSIS

	SCHEDULE	PRESENT VALUE
DOWN PAYMENT	A	$(125,000)
TAX BENEFITS	B	270,000
TAX PENALTIES	C	(106,000)
PURCHASE OPTION	D	21,000
NET PRESENT VALUE		$ 60,000

VIII. TAX CONSEQUENCES TO PURCHASER/LESSOR

A. Investment credit $60,000

B. Depreciates equipment of $600,000 at marginal tax rate of 50% results in tax benefit of $300,000

C. Pays note of $475,000 over 7 years plus interest at 18%, resulting in interest deduction of $366,000

D. Realizes taxable rental income of $840,000 over 7 year lease (rental income equals principal and interest payments on note)

IX. TAX CONSEQUENCES TO SELLER/LESSEE

A. Gives up investment credit and ACRS deductions on equipment

B. Rental payments of $840,000 are deductible for tax purposes

C. Interest income of $366,000 on the note is taxable income

X. LESSOR/PURCHASER STANDPOINT

A. Purchase price equals present value of:

1. ITC and ACRS deductions obtained
2. Less tax penalties for additional income
3. Plus purchase option
4. Plus desired profit

XI. LESSEE/SELLER STANDPOINT

A. Selling price equals present value of:

1. Cash value of tax benefits given up

2. Plus premium for involvement

XII. INTANGIBLE FACTORS

A. Additional time and cost of entering into lease transaction

B. Credit standing

C. Choice of discount rate

D. Strength of economy

FINANCIAL REPORTING CONSIDERATIONS

ACCOUNTING FOR LEASES UNDER THE 1981 TAX ACT

THE FINANCIAL ACCOUNTING STANDARDS BOARD (FASB)

JOHN A. SEIFARTH
PARTNER
ERNST & WHINNEY

Background

Application of FASB Statement 13--Accounting for Leases

FASB PROCESS

- Overview of Exposure Draft
- Exposure Draft withdrawn
- Tentative views
- Technical Bulletin (proposed)
- January 20 meeting

Excerpt from the FASB's December 18, 1981 Action Alert

At the December 16 and 17 Board meetings, the Board discussed the staff's recommendations for issuance of a Statement based on the October 29, 1981 Exposure Draft and concluded that the provisions of that Exposure Draft should be revised and that it should be reexposed for comment. The Board also concluded that the provisions of the revised Exposure Draft should be applied prospectively and that restatement of the accounting for prior transactions would not be required.

With respect to the accounting by a seller of tax benefits, the Board tentatively decided that the proceeds from the sale should be included in the seller's income of the period in which the transaction occurs without allocating the sales price of the tax benefits between tax credits and ACRS deductions. Because the transaction gives rise to differences for tax and financial reporting purposes that function in the same way as timing differences under APB Opinion No. 11, "Accounting for Income Taxes," the Board concluded that the seller should provide for deferred taxes on the proceeds.

With respect to the accounting by a buyer of tax benefits, the Board tentatively decided that the buyer should not allocate the purchase price between the tax credits and the ACRS deductions but should account for the difference between the purchase price and the estimated future tax savings resulting from those benefits over the term of the transaction. On December 16, the Board considered whether the buyer should recognize a return on investment in tax benefits during the early periods in which the investment is being recovered, and a majority of the Board tentatively concluded that the buyer should not. When the Board reconvened on December 17 it asked the staff for additional information on that issue for consideration at a subsequent Board meeting.

The Board also decided that a revised Exposure Draft would not include transactions that are the sale or purchase of tax benefits but that also include an element of financing.

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PANEL DISCUSSION

SELLERS OUTLOOK

ANDREW M. GREENSTEIN
PRESIDENT
EMPIRE TRAILWAYS, INC.

I. THE DECISION TO SELL THE TAX BENEFITS

A. Net operating loss carry forwards and investment tax credit carry forward available to the Seller at the close of its preceding fiscal year

B. Seller's forecast of profitability for the current fiscal year

C. Seller's forecast of profitability for succeeding fiscal years

D. Seller's forecast of tax credits to be available in the current and succeeding fiscal years

II. IDENTIFICATION OF A BUYER

A. Discussion with cooperating banks, attorneys and accountants known to the Seller

B. Reputation, financial stability and motive of the Buyer identified

III. STRUCTURING THE TRANSACTIONS

A. Consideration to be received by Seller for the tax benefits

B. Other concerns of the Buyer, e.g. recapture

C. Preparation of definitive agreements

PANEL DISCUSSION

BUYERS OUTLOOK

HENRY P. EPSTEIN
PRESIDENT
SPECTRUM OFFICE PRODUCTS

I. REASONS FOR CONSIDERING PURCHASE OF COST RECOVERY DEDUCTIONS AND INCENTIVE TAX CREDITS

A. Produce additional cash flow to:

1. Make additional capital investments

2. Minimize cost

II. FACTORS TO BE CONSIDERED BY PURCHASER OF COST RECOVERY DEDUCTIONS AND INVESTMENT TAX CREDITS

A. Reputation and credit standing of seller

B. Legal aspects

C. Financial considerations

1. Availability of cash required

2. Borrowing rate or opportunity cost of cash required

3. Projected corporate earnings for life of lease

4. Marginal tax rate (federal and state)

5. Available and/or anticipated tax credits during life of lease

D. Risk (legal, financial and uncertainty)

E. Accounting considerations:

1. Reduced corporate profits in initial years

2. Balance sheet presentation

F. Philosophical aspects of leasing tax benefits

HOWARD F. BUCHAN
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Howard F. Buchan is a Manager on the Tax Services staff of the Rochester Office of Ernst & Whinney. He joined the firm in Rochester in 1974 as a staff accountant and progressed to Tax Manager in 1981. A native of Rochester, he earned a bachelor of arts degree and MBA from the University of Windsor in Ontario, Canada. He is very active in the United Way and currently serves as corporate member and chairperson of one section of the Allocation Committee. He is also a member of the American Institute of Certified Public Accountants, the Small Business Council of Rochester, and the Rochester Chapters of both the New York State Society of CPA's and the National Association of Accountants.

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Henry P. Epstein is the President and co-founder of Spectrum Office Products, Inc. He was Treasurer of Rochester Stationary Co. until he and his partner purchased that company's office supplies division in 1970 and formed Spectrum Office Products, Inc. In 1975, they purchased the remainder of Rochester Stationary - the office furniture division. He earned a bachelor of science degree from the University of Pennsylvania, Wharton School. He subsequently earned his MBA from the University of Rochester, Executive Development Program, in 1980. Mr. Epstein is Treasurer and on the Board of Directors of the Rochester Philharmonic Orchestra and also a Board member of the Jewish Home and Infirmary. He is also a past president of the Rochester Jaycees and currently serves on the Finance Committees of the Rochester Area Chamber of Commerce, the Rochester Philharmonic Orchestra and the Jewish Home and Infirmary.

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C. Paul Faux is the Managing Partner of the Rochester Office of Ernst & Whinney. He joined the firm in Rochester in 1972 as a staff accountant and progressed to Audit Partner and Managing Partner in 1981. A native of Meadville, Pennsylvania, he spent two years teaching there, after earning a bachelor of science degree from Allegheny College. He subsequently earned his MBA degree from the University of Rochester in 1972. He is Finance Committee Chairman of the Society for the Prevention of Cruelty to Children. He also serves on the Finance Committee and as Assistant Treasurer of Oak Hill Country Club and is a member of the University Club of Rochester. He also currently serves on the Finance Committee of the Rochester Area Chamber of Commerce and is a member of the American Institute of Certified Public Accountants, the Rochester Chapter of the New York State Society of CPA's and is a past president of the Uppper Finger Lakes Chapter of the National Association of Accountants.

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Andrew W. Greenstein is a Partner with the Rochester law firm of Goldstein, Goldman, Kessler & Underberg. He joined the firm in 1958 and has been a partner since 1963. Born in Philadelphia, Pennsylvania, he earned a bachelor of arts degree from Cornell University and later graduated with distinction from the Cornell University School of Law. Mr. Greenstein is a member of the Monroe County, New York State and American Bar Associations. He formerly was a Director of the Jewish Community Federation of Rochester and is presently a Trustee and President of the Rochester Museum and Science Center. He is President and Chief Executive Officer of Empire Trailways, Inc. and Empire Trailways Tours, Inc.

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David J. Whitaker is the President of SNY Leasing Corporation, a subsidiary of Security New York State Corporation. He joined Security Trust Company in 1965 as a marketing representative and progressed to President of SNY Leasing in 1975. A native of Rochester, he attended Union College in Schenectady, New York. He is a member of The American Institute of Banking, the Rochester Area Chamber of Commerce and the American Association of Equipment Lessors. He also serves as Treasurer for both the Al Sigl Center and Otetiana Council (Boy Scouts of America) and is a corporation member of the United Way. He currently serves as President of the Rochester Presbyterian Residence Center (The Valley Manor) and on the Board of Directors for the Easter Seals Society.